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Generations Fall 2021 - The Build Back Better Framework: Good News for Estate Planning

The estate planning community got some very good news on October 28, 2021, when the Biden administration released its Framework for the Build Back Better Act. The Framework contained none of the gift tax, estate tax or trust tax provisions that had been proposed by the House Ways and Means Committee in September as part of Congress' $3.5 trillion budget reconciliation process. The bill proposed by the House had contained substantial changes to the estate and gift tax laws, many of which were surprising and came "out of the blue." There was even greater concern nearly two weeks later when the House Budget Committee released a House Report which consisted of 501 pages intended to explain the 881-page bill. The changes proposed by the House bill and the accompanying House Report would have accelerated the reduction of the lifetime credit against gift and estate tax to January 1, 2022, eliminated valuation discounts for transfers of interests in business entities holding primarily "passive assets," and dramatically changed the rules governing grantor trusts. These proposed changes set off an intense scramble by taxpayers to complete gifts to trusts as rapidly as possible before the new laws became effective. The proposed changes which generated the most concern were the changes that would have affected grantor trusts, i.e., trusts that are treated for federal income tax purposes as if the property in the trust were still owned by the person who created the trust. The grantor trust rules were enacted decades ago when income tax rates were much more steeply graduated than they are today, with top marginal tax rates reaching 70 percent. These rules were intended to prevent wealthy taxpayers from escaping high rates of tax by assigning income-producing property to trusts. If the grantor trust rules apply, the income earned in the trust is taxed at the tax rate of the person who established the trust, even if the trust is irrevocable and the transfer to the trust was a completed gift for tax purposes. Now that marginal income tax rates are much lower than they were when the grantor trust rules were written, practitioners have deliberately drafted trusts to be grantor trusts in order to take advantage of these rules. The grantor trust rules apply only for income tax purposes, not gift or estate tax purposes, so grantor trusts over time became widely used estate planning vehicles. The House felt that practitioners' deliberate use of the grantor trust rules had created tax leakage that needed to be stopped. The House bill had proposed the following changes to the rules:

- Estate Tax Inclusion: Assets owned by a grantor trust would be included in the grantor's estate and subject to estate tax upon the grantor's death, even if the trust was irrevocable and the transfer to the trust had constituted a completed gift.
- Distributions as Gifts: Distributions from a grantor trust during the grantor's lifetime would generally be treated as taxable gifts.
- Taxation Upon Termination of Grantor Trust Status: If the trust's grantor trust status is terminated (i.e., the trust becomes a separate taxpayer, i.e., a "nongrantor" trust), the grantor would be deemed to have made a taxable gift of the value of the trust assets.
- Gain Recognition for Transfers Involving Grantor Trusts. Transfers between a grantor trust and its grantor would be subject to income tax.

The message was clear: Grantor trusts would no longer be a viable gift or estate tax planning strategy. What caused the greatest stir, though, was that the House Budget Committee subsequently announced that it intended the above rules to apply to all post-enactment transfers between a grantor and a grantor trust, even grantor trusts that were created prior to the date of enactment and are now irrevocable, meaning they cannot be changed. Those proposed rules caught the tax community by surprise and seemed to change the rules on taxpayers who had engaged in legitimate tax-planning strategies that were widely used and sanctioned by numerous rulings and cases. The proposed changes created enormous potential problems for these trust arrangements. How would a grantor continue to fund premiums for a life insurance policy held by an irrevocable life insurance trust without subjecting a portion of the insurance proceeds to estate tax? How could a grantor-retained annuity trust pay a required annuity in kind without generating a substantial income tax? These were not the rules in effect when the arrangements were put in place and made irrevocable. It is one thing to change planning techniques going forward when the rules change, but quite another to have to deal with dramatic changes in rules that impact existing arrangements that cannot be changed. For those reasons, taxpayers and their advisers were enormously relieved to see that the Biden administration's Framework for the Build Back Better Act contained none of those changes. The legislative process still has a long way to go, and no one can say whether the Build Back Better Act will pass, or if it does, what will be included in its final version. The tax planning community can, at least for the moment, catch their collective breath, but when the dust settles, they may study the Framework more closely and notice that it proposes raising an additional $400 billion over the next 10 years through increasing resources for the Internal Revenue Service and promoting tighter enforcement of existing tax laws. From the perspective of the estate planning community, it appears that every rose has its thorns. Would you like to receive the *Day Pitney Generations Newsletter*? Sign up here. Day Pitney Generations Newsletter - Fall 2021 (pdf)

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