2021 PROPOSED CHANGES TO ESTATE AND INCOME TAX

The new $3.5 trillion infrastructure proposal known as the "Build Back Better Act" (the "Proposal") plans to pay for its initiatives in large part by increasing taxes on high net worth and high-income earners. As a result, there are proposed changes to income and transfer taxes which will substantially affect estate planning for high net worth individuals, such as increasing capital gains and ordinary income taxes for high income taxpayers, decreasing transfer tax exemptions, subjecting certain irrevocable grantor trusts to the estate tax, and changing the "grantor trust" income tax rules.

Estate, Gift and GST Tax

The Proposal would change the gift, estate and generation-skipping transfer (GST) tax rules as follows:

1. Decrease Exemptions. The current estate, gift and GST exemption amount is $10 million, which on a cost-of-living adjusted basis is $11.7 million. The Proposal seeks to change the estate, gift and GST exemption amount back to $5 million, which is increased each year by a cost-of-living adjustment. This change would be effective as of January 1, 2022, and based on the consumer price index adjustment would be equal to $6,030,000.
2. Irrevocable Grantor Trusts. Currently, income and deductions in an irrevocable grantor trust are reported on the grantor's income tax return, which means that the grantor is treated as the owner of the assets. A principal benefit of this treatment is the ability of the grantor to pay taxes on trust income (further enhancing the value of the trust while decreasing the taxable estate of the grantor). Moreover, an irrevocable grantor trust may buy assets from the grantor without the purchase being treated as a sale for income tax purposes, thus producing no gain. When properly structured, an irrevocable grantor trust is not subject to estate tax. Under the Proposal, an irrevocable grantor trust executed and funded after the Proposal's enactment, or that engage in sales or other borrowing transactions after enactment, would be subject to estate tax (thus aligning the income and estate tax treatment of such trusts). The Proposal should not affect irrevocable grantor trusts executed and funded before the enactment date. However, it is unclear whether new contributions made to existing irrevocable grantor trusts after the enactment date would be subject to estate tax.
3. Valuation Discounts. The liquidation value of an ownership interest in an entity that is not publicly traded and does not have voting control is discounted for third-party buyers. Under the Proposal, valuation discounts on transfers of closely-held non-business assets would be removed when calculating the asset's value for gift and estate taxes. If enacted, this provision would affect transfers after the bill is passed.

Income Tax

The Proposal would change income tax as follows:

1. Ordinary Income Taxes. The Proposal increases the highest marginal ordinary income tax rate from 37% to 39.6%, which will apply to taxable income over $400,000 for single filers and $450,000 for married filing jointly. If enacted, this provision would be effective January 1, 2022.

2. <u>Capital Gains</u>. The Proposal provides for the capital gains tax rate to increase from 20% to 25% for single filers with taxable income over $400,000 and married filing jointly with income over $450,000. If enacted, this provision would be effective for taxable years after September 13, 2021.
3. <u>Surtaxes</u>. The Proposal imposes an additional 3% tax on income over $5 million. If enacted, this provision would be effective on January 1, 2022.
4. <u>Corporate Tax Rates</u>. Currently, the corporate tax rate is a flat 21%. However, the Proposal seeks to replace the corporate tax rate with a sliding rate from 18% on the first $400,000 of income, 21% on income up to $5 million and 26.5% on income over $10 million.
5. <u>IRAs</u>. The Proposal seeks to change the following rules on individual retirement accounts (IRAs):
    a. At the end of the prior year, if the value of all of the taxpayer's IRAs exceed $10 million, then IRA contributions would be barred. This provision applies to single filers with income over $400,000, married filing jointly with income over $450,000 and heads of households with income over $425,000.
    b. Limit conversions from traditional IRAs to Roth IRAs for single filers with income over $400,000 or married filing jointly with income over $450,000.
    c. Disallows certain investments in IRAs such as investing in assets that require the owner to qualify as an accredited investor.
6. <u>Sales to Irrevocable Grantor Trust</u>. Currently, sales between a grantor and an irrevocable grantor trust are ignored. However, under the Proposal, such sales would trigger income tax. If enacted, this provision would be effective on the date that the Proposal becomes law. It is unclear whether this provision would apply to sales after the enactment date to existing irrevocable grantor trusts.

This update is intended to provide a brief summary of the proposed changes to estate and income tax. The Build Back Better Act has not become law yet, so it is important to analyze your options and risks when planning for your future. If you have any questions, please consult with one of our attorneys.