September 30, 2021

Build Back Better Act: Proposed Changes to Gift and Estate Tax Law

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In short, the proposed Build Back Better Act ("BBBA") does the following:

1. Effective January 1, 2022, the BBBA reduces the gift, estate and GST tax exemptions from $11,700,000 per person (or $23,400,000 for a married couple) to an amount estimated to be $6,020,000 per person (or $12,040,000 for a married couple).

2. Effective the date the BBBA is enacted (passed by Congress and signed by the President), the benefits of a "grantor trust" would be eliminated.

3. Effective the date the BBBA is enacted, discounts for interests in a non-operating business (i.e., passive investments) would be eliminated.

Disclaimer: As of the time this article was drafted, the BBBA was in the House of Representatives (the "House") and the House had not voted on the BBBA. The BBBA will likely be modified as it moves its way through Congress; therefore, these proposed provisions could be modified or removed and the effective dates could change.

I. Reduction in Gift, Estate, and GST Tax Exemption.

A. Current Law. The current gift and estate tax exemption is $11,700,000 per person ($23,400,000 for a married couple); these amounts reflect increases from $5,000,000 per person in 2017 as part of the Tax Cuts and Jobs Act of 2017 ("TCJA"), and are scheduled to revert to approximately $6,000,000 per person in 2026 if no other action is taken by Congress.

B. BBBA. The BBBA accelerates the expiration of the temporary increase in exemption for estates of decedents dying and gifts made after December 31, 2021. As a result, the anticipated exemption for 2022 would be $6,020,000.

C. Planning. Anyone who has made taxable gifts of $6,020,000 or more on December 31, 2021 will have no remaining exemption on January 1, 2022. In order to preserve some (or all) of the $5,680,000 of exemption that will disappear on January 1, 2022, an individual would need to make gifts in excess of $6,020,000 (including prior gifts) by December 31, 2021. For example, if an individual has made taxable gifts of $3,000,000, he or she would need to make a gift of $8,700,000 before the end of the year to fully utilize the current exemption.

II. Grantor Trusts.

A. Current Law. If a settlor establishes a trust and retains certain enumerated benefits in or powers over the trust, the trust is treated as a "grantor trust" for federal income tax purposes and all trust income is taxable to the grantor. Establishing a trust as a grantor trust results in larger gifts being transferred to descendants because the settlor, rather than the trust, will be responsible for the taxes associated with the assets held in the trust. In addition, most transactions between a grantor trust and its settlor are ignored for income tax purposes, including sales of appreciated assets, rent payments on property, and interest on promissory notes.

B. BBBA. The proposed legislation grandfathers grantor trusts established before the date of enactment; therefore, grantor trusts that do not receive any additional contributions or enter into transactions with the settlor will not be affected; however, additional gifts to grandfathered grantor trusts after the date of enactment would be subject to the new rules. In addition, sales to (or from) the grantor trust by the settlor may be taxable transactions (as well as rental payments and interest payments).

In addition, the proposed legislation affects new grantor trusts (or contributions to grandfathered grantor trusts) in the following ways:

1. Grantor trusts, whether revocable or irrevocable, will be brought back into the settlor's estate at death;

2. Sales between an irrevocable grantor trust and the settlor will be treated as sales to third parties (triggering gain on appreciated property);

3. Exchanges of property between the settlor and an irrevocable grantor trust trigger gain on appreciated property;

4. Distributions from a grantor trust to anyone other than the settlor or the settlor's spouse will be treated as taxable gifts; and

5. If the trust ceases to be a grantor trust, all assets will be treated as a taxable gift by the settlor.

As a result of these changes, establishing (or contributing to) any trust that is treated as a grantor trust would have substantial negative tax consequences. These rules will eliminate the benefits of a number of special trusts commonly used today: Qualified Personal Residence Trusts, Grantor Retained Annuity Trusts, and Spousal Lifetime Access Trusts. In addition, it will be much more difficult to establish an irrevocable trust that will own a life insurance policy without triggering these new rules.

C. Planning.

1. **Grantor Trusts**. Gifts and sales to grantor trusts prior to enactment of the legislation should not result in negative tax consequences; however, contributions should not be made to grantor trusts after the date of enactment. At this time, it is unclear whether a sale of property between the settlor and a grantor trust after the date of enactment will be a taxable transaction. Since the BBBA will likely be modified as it moves its way through Congress, it is possible the effective date could change, so individuals contemplating a sale or exchange transaction with a grantor trust should consider that risk.

2. **Non-Grantor Trusts**. Non-grantor trusts remain untouched by the grantor trust rules; however, if you contribute life insurance to a non-grantor trust or such a trust purchases a life insurance policy, it will generally be treated as a grantor trust unless extra precautions are taken (e.g., gifting fully paid life insurance to the trust, gifting cash to the trust to pay premiums that would be held in a non-

interest bearing account, loaning cash to the trust for premium payments, or paying premiums directly to the life insurance company rather than to the trust).

III. No Discount Valuations for Passive Investments.

A. Current Law. The gift tax and estate tax apply to the fair market value of the property being transferred on the date of transfer. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The fair market value of an interest in an entity may be less than the owner's proportionate share of the value of the entity's assets because of a lack of control and/or a lack of marketability; thus, discounts for lack of marketability and/or lack of control have historically been applied when valuing such interests.

B. BBA. The proposed legislation would eliminate discounts for certain "nonbusiness assets" by treating such assets as if they had been transferred directly, rather than as part of an entity. Nonbusiness assets are defined to include any passive asset held for the production or collection of income, but which is not used in the active conduct of a trade or business. There is an exception provided for assets needed for working capital and certain hedging transactions. If the entity holds as a passive asset a 10% or greater interest in any other entity, the proposed legislation includes a look-through rule treating the assets in that lower entity as being held directly by the top entity. This rule is applied successively to any 10% interest in another entity held by any lower tier entities.

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