

Trusts & Estates Alert

June 2021

From The Green Book: Administration's Tax Proposals For Individual Income Taxation

For the first time in almost five years, the Treasury Department has released its "[Green Book](#)." The Green Book provides general explanations of the Biden administration's revenue proposals for the fiscal year 2022, including various tax proposals recently previewed in President Biden's American Families Plan.

For individuals, the Green Book highlights the administration's focus on changing the income tax rates and rules applicable to "high earners," with a particular emphasis on increasing the recognition and taxation of capital gains. While the proposals do not include a reduction in the federal gift and estate tax exemptions or an increase in federal gift and estate tax rates, they do include taxing unrealized gains and eliminating the "step-up" in basis at death, which would have both a profound impact on estate planning for appreciated assets and wide-ranging implications for commonly used estate planning techniques such as transfers to grantor trusts, as well as long-term income tax consequences for trusts more generally.

The effective date for most of the proposals is Jan. 1, 2022, except for the proposed increase in capital gains tax rates, which would likely be effective retroactive to April 28, 2021.

As you review this alert, it is critical to keep in mind that the Green Book is a wish list, not legislation. We cannot predict which items will advance to legislation or when any legislation will be effective, notwithstanding the proposed effective dates.



Notable Individual Tax Proposals

Increase Top Marginal Income Tax Rates From 37% To 39.6% For High Earners

The administration proposes an increase in the top individual income tax rate to 39.6%. For 2022, that top rate would apply to taxable income over \$509,300 for married joint filers and \$452,700 for single filers (effectively moving a portion of the current 35% bracket into the 39.6% bracket). For 2021, the top individual income tax rate is 37% and applies to taxable income over \$628,300 for married joint filers and \$523,600 for single filers. Thresholds would be inflation-indexed after 2022.

Proposed Effective Date. Taxable years beginning after **Dec. 31, 2021.**

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Tax Capital Gains and Qualified Dividends of High Earners at Ordinary Income Rates (up to 39.6%) Instead of Capital Gains Rates (20%)

For taxpayers with income over \$1 million (\$500,000 for married filing separately), the administration's proposal would tax long-term capital gains and qualified dividends (capital income) at ordinary income tax rates of up to 39.6% (if the top ordinary income tax rate is increased) plus the 3.8% net investment income tax to the extent it applies. Currently, capital income is taxed at a top rate of 20% (or 23.8% if the 3.8% net investment income tax applies).

It is unclear whether the higher tax rate will apply only to capital income in excess of the threshold or to all capital income if capital income exceeds the threshold. These income thresholds would be inflation-indexed after 2022.

Proposed Effective Date. Effective for gains recognized after the date of announcement (which is believed to be the release of the American Families Plan on **April 28, 2021**). Note this is the only proposal with a **retroactive** effective date.

Treat Gifts and Bequests of Appreciated Property as Realization Events for Capital Gain

Under current law, lifetime gifts and transfers of assets at death do not trigger gain. Gift recipients take a "carry-over" income tax basis in the asset (deferring gain recognition until a later taxable transfer, if any), while appreciated inherited assets receive a "stepped-up" basis to fair market value as of the decedent's death (avoiding capital gains tax on any appreciation). The administration proposes to change these rules.

Gifts and Bequests as Realization Events. Gifts and bequests of appreciated assets would trigger recognition of any inherent gain, which would be taxable to the transferor (although the tax would be deductible by a decedent's estate on an estate tax return, if any). Beneficiaries would receive the assets with a stepped-up basis, but as a result of the payment of capital gains tax at the time of the gift or bequest.

Realization on In-Kind Transfers To/From Trusts and Partnerships. In-kind transfers of property to or from trusts and partnerships or other pass-through entities would trigger recognition of gain. **An exclusion**

would apply for transfers to a revocable grantor trust; however, that trust's transfer of an asset to any person other than the donor or the donor's U.S. spouse would generate gain. Realization of gain on revocable trust assets also would be triggered if the trust becomes irrevocable or at the donor's death.

A "transfer" for purposes of gain recognition would be defined under the gift and estate tax provisions. The Green Book does not specify whether transactions currently disregarded for income tax purposes (such as sales by a grantor to an irrevocable grantor trust) would constitute "transfers."

90-Year Mark to Market. A trust (other than a revocable grantor trust) or pass-through entity would recognize gain on any property that has not experienced a recognition event within the prior 90 years. The initial testing period would begin on Jan. 1, 1940, making Dec. 31, 2030, the first possible date of a recognition event for a trust or partnership.

No Valuation Discounts When Determining Gain.

For purposes of taxing the capital gain upon the transfer of appreciated assets, the value of the asset would be determined under existing gift and estate tax methodologies, except that a transfer of a partial interest in an asset would be valued based on its proportional share of the fair market value of the entire property (i.e., no discounts in value for transfers of partial interests). It is unclear whether or how this rule would interact with the valuation of assets for gift and estate tax purposes.

Exclusions. The following exclusions would apply to these gain realization events:

- **Transfers to U.S. Spouses.** Transfers of assets by a decedent to a "U.S. spouse" would carry-over basis, with gain deferred until the surviving spouse disposes of the asset or dies.
- **Transfers to Charities.** Transfers of appreciated assets by a decedent to charities would carry-over basis and would not generate a taxable gain to the charity. Transfers to a split-interest trust (for example, a charitable remainder trust, where the charity is entitled to only the remainder value of the trust) would generate taxable gain for the donor, but with an exclusion for the charity's proportionate share of that gain.

- **\$1 Million Exemption (Portable).** Each individual would have a \$1 million exclusion (\$2 million for married couples) from capital gain recognition for assets transferred by gift or at death. The exclusion would be inflation-indexed and portable between spouses, subject to the same rules for estate and gift tax exemption portability.

For lifetime gifts of appreciated assets that are shielded by the donor's \$1 million exemption, the gift recipient takes a carry-over basis (no step-up), which effectively provides gain deferral in this case rather than a full exclusion. Transfers of appreciated assets at death and gifts of appreciated assets to which the donor's \$1 million exemption did not apply would receive a basis step-up to their value at the date of transfer.

- **Tangible Personal Property.** No gain would be recognized on transfers of tangible personal property (such as household furnishings and personal effects), excluding collectibles.
- **\$250,000 Gain on Residences (Portable).** The \$250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse (so \$500,000 per married couple).
- **Family-Owned Businesses.** Appreciation in certain family-owned and -operated businesses would not be taxed until the business is sold or ceases to be family-owned and -operated.
- **15-Year Deferral on Transfers of Illiquid Assets at Death.** A 15-year fixed-rate payment plan would be available for the capital gains tax due on the transfer of other appreciated illiquid assets at death, subject to any security requirements imposed by the IRS.
- **Losses and Offsets.** For transfers at death, capital losses and carry-forwards would be allowed as offsets against capital gains.
- **Qualified Small-Business Stock.** The exclusion under current law for capital gain on certain small-business stock would continue to apply.

Proposed Effective Date. Effective for gifts made and property owned by decedents dying **after Dec. 31, 2021**, and for certain property of trusts and partnerships **on Jan. 1, 2022**.

Tax Carried (Profits) Interests as Ordinary Income for Earners Over \$400,000

Certain partners in partnerships (such as managers of hedge funds or private equity funds) receive partnership interests referred to as "profits interests" or "carried interests." The administration proposes to tax a partner's share of income from an "investment services partnership interest" in an investment partnership as ordinary income (at potentially 39.6%) rather than as capital gain (20%), if the partner's taxable income from all sources exceeds \$400,000. Gain from the sale of a partnership interest also would likely be treated as ordinary income, not capital gain, if the partner's taxable income is above the \$400,000 threshold. In addition, partners in investment partnerships would be subject to self-employment taxes on such income.

Proposed Effective Date. Effective for taxpayers with taxable income (from all sources) in excess of \$400,000 for taxable years **after Dec. 31, 2021**.

Limit Deferral of Gain on Like-Kind Exchanges of Real Estate to \$500,000

Currently, owners of appreciated real property used in a trade or business or held for investment can defer gain by exchanging the property for other "like kind" real property. Under the administration's proposal, a taxpayer could defer only up to \$500,000 of gain each year (\$1 million for married joint filers) for these like-kind exchanges. Gain in excess of that amount would be recognized by the taxpayer in the taxable year of the exchange.

Proposed Effective Date. The proposal would be effective for exchanges completed in taxable years beginning **after Dec. 31, 2021**.

What Can Be Done Now

Below are some planning options to keep in mind if one or more of these proposals gain traction:

- **Accelerate Capital Gains.** Recognizing gains in 2021 may permit you to take advantage of the lower 20% capital gains rate, ***assuming the effective date of any legislation allows a window for acceleration.*** The administration's proposed effective date for the increased capital gains rate (likely April 28, 2021), if adopted, would foreclose this opportunity.
- **Finalize Like-Kind Exchanges.** Any in-progress or contemplated like-kind exchanges of real property should be finalized by the end of 2021 to take advantage of the full gain deferral available under current laws.
- **Complete Grantor Trust Planning.** Planning with irrevocable grantor trusts (where the creator is treated as the owner of the trust assets for income tax purposes) should be completed in 2021 to take advantage of any possible "grandfathering" benefits that may be provided for trusts created before the effective date of new legislation. The key will be to ensure flexibility in both the planning and the terms of the trust. For example, rather than mandating trust distributions to beneficiaries at certain ages or requiring division of a trust among beneficiaries upon the occurrence of certain events (which may trigger gain realization), these distributions or divisions could be made at the trustee's discretion, taking into account your expressed goals for the trust beneficiaries, their needs, the trust's circumstances, and the tax laws at the time.

- **Review Liquidity Needs and Consider Life Insurance.** Any proposal making gifts and bequests realization events for capital gains tax purposes will increase the challenges of planning with highly appreciated assets, particularly if there is an increase in the federal capital gains rate. (State tax liability also may apply, as many states tie their taxable income to the determination of federal taxable income.) This proposal also could affect far more families than the existing estate and gift tax regime, as the current estate and gift tax exemption of \$11.7 million is much higher than the proposed \$1 million exemption. Ensuring sufficient sources of liquidity for taxes, including through life insurance, will be important to manage the possible exposure.

We will continue to monitor these proposals and to work on planning techniques to address their impact if these proposals are enacted. If you have an existing irrevocable grantor trust, we encourage you to contact your primary Loeb & Loeb estate lawyer to discuss it.

Related Professionals

Cristine M. Sapers csapers@loeb.com
Alyse N. Pelavin apelavin@loeb.com
Jennifer M. Smith jsmith@loeb.com

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