**Trusts & Estates Update**
September 2021

# House Ways and Means Committee Issues Draft for Proposed Tax Changes

Earlier this week, the House Ways and Means Committee issued draft text for proposed tax changes to include in the Democrats' broader budget reconciliation bill. The proposals include significant changes to the tax rates and rules applicable to individuals, trusts and estates. Notably, the proposals accelerate the reduction of the current estate and gift tax exemption from $11.7 million (in 2021) to $5 million (inflation-adjusted) effective Jan. 1, 2022. For individuals and certain other non-corporate taxpayers, the proposals increase ordinary income and capital gains tax rates and impose a 3% tax surcharge on individuals with more than $5 million of modified adjusted gross income (AGI) ($2.5 million for married individuals filing separately and $100,000 for estates and trusts). While none of the changes currently would be retroactive to the beginning of this year, some would be effective as of Sept. 13, 2021 (the date of the legislation's introduction), while others would be effective as of the legislation's enactment or as of Jan. 1, 2022.

**In reviewing this alert, please keep in mind that this is draft legislation, which is subject to negotiation and amendment. Enactment of any of these tax changes likely will require the support of most House Democrats and all Senate Democrats. Moreover, for some of these proposals, there are competing proposals from the Senate and the Biden administration. Since these proposals will evolve, we cannot predict what changes will be enacted, or when they will take effect, notwithstanding the proposed effective dates, making current decisions difficult.**

## Notable Estate and Gift Tax Proposals

### Termination of Increased Estate and Gift Tax Exemption (Unified Credit) in 2022

The proposals reduce the federal estate and gift tax exemption from the current $11.7 million (inflation-adjusted for 2021) to $5 million (inflation-adjusted) effective Jan. 1, 2022 instead of Jan. 1, 2026. The inflation-adjusted exemption is anticipated to be just over $6 million.

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

### Changes to Tax Rules Applicable to Grantor Trusts

The proposals change the tax rules for irrevocable grantor trusts to: (i) include the value of the trust assets in the grantor's estate at death, (ii) impose gift tax on any distribution from the trust (other than to the grantor or the grantor's spouse) or on the entire value of the trust if grantor trust status terminates during the grantor's lifetime and (iii) recognize (rather than disregard) sales or exchanges of property between the grantor and grantor trust for income tax purposes, similar to sales between the grantor and a third party.

Some grandfathering protection appears to apply, as the proposed changes are effective only for grantor trusts created on or after the date of enactment or to any portion of a pre-existing grantor trust that is attributable to a contribution made on or after such date. It is unclear whether these changes would affect open transactions with pre-existing grantor trusts (such as where a promissory note is outstanding for a prior installment sale to a trust).

***Proposed Effective Date***. Applies to grantor trusts created and/or portions of existing grantor trusts attributable to contributions made on or after the **date of enactment**.

### Elimination of Valuation Discounts on Transfers of Nonbusiness Assets

For transfers of interests in a closely held entity, the proposals eliminate valuation discounts for lack of control or lack of marketability that are attributable to the nonbusiness assets held by the entity. Nonbusiness assets are passive assets that are held for the production of income and not used in the active conduct of a trade or business. Exceptions are provided for assets used in hedging transactions or as working capital of a business.

***Proposed Effective Date***. Applies to transfers made after the **date of enactment**.

## Notable Individual Income Tax Proposals

### Increase in Top Marginal Income Tax Rates From 37% to 39.6% for High Earners

The proposals increase the top individual income tax rate to 39.6% on taxable income over $450,000 for married joint filers and $400,000 for single filers. For 2021, this top rate is 37% and applies to taxable income over $628,300 for married joint filers and $523,600 for single filers. The rate increase also applies to estates and trusts.

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

### Increase in Long-Term Capital Gains Tax Rate From 20% to 25%

The proposals increase the long-term capital gains tax rate to 25% for gains recognized after Sept. 13, 2021, the date of the legislation's introduction. The current 20% rate would continue to apply to gains and losses for the portion of the taxable year on or before the introduction date, including to gains from transactions entered into before this date pursuant to a written binding contract.

***Proposed Effective Date***. Effective for gains recognized after **Sept. 13, 2021** (exception applies for transactions subject to prior binding contracts that have not been modified in any material respect).

### 3% Surcharge on High Income Individuals, Trusts and Estates

For non-corporate taxpayers, the proposals impose a 3% tax on a taxpayer's modified AGI in excess of $5 million ($2.5 million for married, separate filers) or $100,000 for trusts or estates.

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

### Expansion of Net Investment Income Tax to Trade or Business Investment Income

The proposals expand the 3.8% net investment income tax to cover net investment income derived in the ordinary course of a trade or business for high income taxpayers ($400,000 taxable income for single filers; $500,000 for married joint filers), as well as for trusts and estates.

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

### Modification of Rules for Retirement Accounts

For high earners ($400,000 single filers; $450,000 married joint filers) whose aggregate IRAs and defined contribution retirement account values generally exceed $10 million, the proposals limit further contributions to the accounts and require the taxpayers to take a higher minimum required distribution. Other proposed changes include the elimination of so-called "back-door" Roth

IRA conversion strategies, which permit non-deductible contributions to a traditional IRA with a later conversion to a Roth IRA, thereby avoiding the income contribution limits on direct Roth IRA contributions.

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

## Other Notable Provisions

### Modification of Carried Interest Taxation

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 partner’s income attributable to the carried interest is taxed as long-term capital gain if certain holding period and other requirements are met. The proposals increase the holding period for long-term capital gain treatment from three to five years (although the three-year holding period is kept for real property trades or businesses and taxpayers with AGI of less than $400,000). In addition, this proposal is applied without regard to any election under Section 83(b).

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

### Limits on Gain Exclusion for Qualified Small Business Stock

Owners of qualifying small business stock (QSBS) may exclude from tax some or all of the gain realized from the sale of stock held for more than five years. The initial exclusion rate of 50% was increased to 75% for QSBS acquired between Feb. 17, 2009 and Sept. 27, 2010, and 100% for QSBS acquired after Sept. 27, 2010. The proposals cap the QSBS exclusion rate to 50% for taxpayers with AGI exceeding $400,000 and for trusts and estates.

***Proposed Effective Date***. Effective for sales and exchanges after **Sept. 13, 2021** (exception applies for sales subject to prior binding contracts that have not been modified in any material respect).

### Temporary Tax-Free Reorganization of Eligible S Corporations to Partnerships

The proposals allow eligible S corporations to reorganize as partnerships without triggering tax. To be eligible, the S corporation must have been an S corporation on May 13, 1996, and it must completely liquidate and transfer substantially all of its assets and liabilities to a domestic partnership during the two-year period beginning on Dec. 31, 2021.

## What Now?

Given the significance of these proposals, we encourage you to contact your Loeb & Loeb estate lawyer as soon as possible to ensure adequate time to evaluate your options. We will continue to monitor the progress of the tax legislation.

### Related Professionals

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



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