Proposed Tax Legislation Would Dramatically Impact Private Wealth Planning

September 24, 2021

Overview

The House Ways and Means Committee recently proposed new draft federal tax legislation that would dramatically affect the Private Wealth area. Many of the changes are time sensitive. Thankfully, unlike previously publicized tax reform proposals, the existing "step-up" in basis rules that apply at the time of a decedent's death are not being altered by the new draft legislation. A summary of the proposed changes follows. Please note that the proposals discussed below are subject to further revision, perhaps significantly so, as the draft legislation works its way through Congressional committees in the different houses of Congress and toward enactment.

Estate/Gift/GST Tax

Currently, the exemption against estate, gift and generation-skipping transfer (GST) tax, as a result of the Tax Cuts and Jobs Act of 2017, is $10 million per person, indexed for inflation (i.e., $11.7 million for 2021). This increased exemption amount is set to sunset after December 31, 2025. The current proposals, however, would reduce the exemption amount to $5 million, indexed for inflation using a base year of 2010, beginning on January 1, 2022 (i.e., approximately $6,020,000 for 2022).

Clients who wish to take advantage of the current $11.7 million exemption before the end of 2021 may do so by accelerating their estate planning goals and making lifetime gifts before the year's end to use up remaining exemption amounts, as this change would be effective next year.

Grantor Trusts

Under current law, a donor can establish a so-called "grantor trust," with trust property treated as being owned by the grantor for income tax purposes, but with trust property outside of the grantor's estate for estate tax purposes. As a common estate planning technique, a grantor will often sell or exchange assets to or with a grantor trust with no income tax consequence.

The new proposals would eliminate many of the tax benefits of establishing grantor trusts. For example, under the draft legislation, if a grantor is treated as the owner of a trust for income tax purposes, the trust property would now be included in the grantor's estate for estate tax purposes. This would include any appreciation on the trust's assets in the grantor's estate as well. The new legislation would also classify distributions during the grantor's lifetime from a grantor trust to a trust beneficiary, other than the grantor or the grantor's spouse, as a gift to the beneficiary by the grantor, with an offset for the grantor's initial gift to the trust. In other words, the distribution from a grantor trust to a trust beneficiary would be treated as a gift to the beneficiary by the grantor. Additionally, sales and exchanges with a grantor trust by a grantor would no longer be disregarded for income tax purposes.

This potential change would apply to grantor trusts that are settled after enactment (as opposed to after the end of the year) of the legislation and to post-enactment contributions to and transactions with existing grantor trusts. This could largely eliminate the benefit of common estate planning techniques such as grantor retained annuity trusts (GRATs), sales to grantor trusts, spousal lifetime access trusts (SLATs), qualified personal residence trusts (QPRTs) and irrevocable life insurance trusts (ILITs).

ILITs are estate planning vehicles that are usually grantor trusts. Typically, an ILIT holds life insurance policies and gifts are made to the ILIT each year in order to pay the annual life insurance premiums. Clients with ILITs may wish to pre-fund their ILIT with multiple years' worth of life insurance premiums to avoid having such contributions included in the grantor's estate for estate tax purposes (if the current draft legislation shows signs of being enacted in its current form) before the enactment of draft legislation.

In addition to the above considerations regarding ILITs, clients may want to consider creating and funding certain grantor trusts prior to the enactment of the new tax legislation in order to preserve favorable tax status.

Valuation Discounts

The new tax proposals also take aim at valuation discounts for non-business assets (e.g., cash, publicly traded stocks and bonds, debt instruments, etc.) that are held in limited liability companies (LLCs), partnerships and other private entities. Presently, if a donor makes a gift of a minority or non-controlling interest in a private entity, the value of the gift is arguably less than the value of the proportional amount of the entity being transferred due to discounts for lack of marketability and lack of control. The new tax proposals would eradicate these discounts for transfers on or after the date of enactment if the entity's assets include publicly-traded securities, non-operating cash or other passive, non-business assets. For example, under current law, a transfer of 20 percent of an LLC to a non-managing member would likely be considered a transfer of less than 20 percent of the value of the LLC due to discounts for lack of marketability and lack of control. The new legislation would result in the transfer of 20 percent of an LLC being considered a transfer of 20 percent of the value of the LLC, increasing the amount of the gift being made.

Clients who want to make lifetime gifts utilizing valuation discounts with interests in entities holding non-business assets may wish to do so before enactment of any tax legislation in order to take advantage of these discounts for lack of marketability and lack of control.

Retirement Accounts

The new tax proposals would prevent certain high-income earners (generally, single taxpayers exceeding $400,000 in income and joint filers exceeding $450,000 in income) from converting pre-tax employee contributions to a qualified retirement plan to a Roth account and from converting pre-tax IRA balances into Roth IRAs. If enacted, all taxpayers, regardless of income, would not be able to convert any after-tax contributions made to qualified retirement plans or IRAs to a Roth account or Roth IRA, effective for tax years beginning January 1, 2022.

There also are proposed significant changes for large retirement accounts. Beginning in 2022, regardless of a taxpayer's age, taxpayers earning more than $400,000 (or $450,000 for joint filers) with a combined traditional IRA, Roth IRA and defined contribution retirement account balance exceeding $10 million would be required to withdraw 50 percent of the balance over $10 million. For any aggregate traditional IRA, Roth IRA and defined contribution retirement plan balance over $20 million, 100 percent of the excess over $20 million must be withdrawn from Roth accounts up to the lesser of (1) the amount needed to bring the total balance of such accounts below $20 million and (2) the aggregate balance of the taxpayer's Roth accounts. The taxpayer will also have to pay income tax on such withdrawn amounts on an annual basis. Additionally, for high-income taxpayers, the new provisions would prohibit any additional contributions to traditional and Roth IRAs if the aggregate balance of a taxpayer's retirement accounts exceeds $10 million.

Conclusion

The above proposals make significant changes to the estate planning landscape for all high-net-worth individuals, including the potential termination of many estate planning methods that advisors have traditionally recommended. While there has been political momentum to pass tax legislation that will increase federal revenue, these tax proposals may very well not be enacted, if at all, without further amendment. Due to the effective dates for many of the proposed changes, however, you should consider how such variations to existing legislation may affect your estate planning prior to the final enactment of new legislation.

We encourage you to get in touch with us regarding your estate plan so that we can review it and make recommendations regarding the potential impact of the draft legislation on your estate planning goals.

CONTACTS

For more information, please contact your Katten attorney or any member of Katten's Private Wealth practice.

NAME	TITLE	PHONE	EMAIL
Joshua S. Rubenstein	National Chair	+1.212.940.7150	joshua.rubenstein@katten.com
CHARLOTTE			
Diane B. Burks	Special Counsel	+1.704.344.3153	diane.burks@katten.com
CHICAGO			
Charles Harris	Chicago Co-Chair	+1.312.902.5213	charles.harris@katten.com
Michael O. Hartz	Chicago Co-Chair	+1.312.902.5279	michael.hartz@katten.com
David M. Allen	Partner	+1.312.902.5260	david.allen@katten.com
Michelle R. Canerday	Partner	+1.312.902.5515	michelle.canerday@katten.com
Mackenzie Collins	Associate	+1.312.902.5438	mackenzie.collins@katten.com
Adam M. Damerow	Partner	+1.312.902.5250	adam.damerow@katten.com
Hadar R. Danieli	Special Counsel	+1.312.902.5581	hadar.danieli@katten.com
Jeffrey Glickman	Associate	+1.312.902.5227	jeffrey.glickman@katten.com
Stuart E. Grass	Of Counsel	+1.312.902.5276	stuart.grass@katten.com
Nicholas Heuer	Associate	+1.312.577.8317	nicholas.heuer@katten.com
Caitlin A. Kelly	Associate	+1.312.902.5419	caitlin.kelly@katten.com
Tye J. Klooster	Partner	+1.312.902.5449	tye.klooster@katten.com
Jonathan Kohl	Associate	+1.312.902.5619	jon.kohl@katten.com
Louis A. Laski	Associate	+1.312.902.5607	louis.laski@katten.com
Benjamin Lavin	Associate	+1.312.902.5670	ben.lavin@katten.com
Tracy E. Lyerly	Special Counsel	+1.312.902.5352	tracy.lyerly@katten.com
Andrew L. McKay	Partner	+1.312.902.5315	andrew.mckay@katten.com
Allan B. Muchin	Of Counsel	+1.312.902.5238	allan.muchin@katten.com
Maureen C. Mullen	Associate	+1.312.902.5209	maureen.mullen@katten.com
Kelli Chase Plotz	Special Counsel	+1.312.902.5347	kelli.plotz@katten.com
Matthew Sperry	Partner	+1.312.902.5557	matthew.sperry@katten.com
Bonita L. Stone	Partner	+1.312.902.5262	bonita.stone@katten.com

DALLAS

Nancy Collins	Associate	+1.214.765.3626	nancy.collins@katten.com

LOS ANGELES – CENTURY CITY

Abby Feinman	Los Angeles Chair	+1.310.788.4722	abby.feinman@katten.com
Carol A. Johnston	Partner	+1.310.788.4505	carol.johnston@katten.com
Avi Pariser	Associate	+1.310.788.4514	avi.pariser@katten.com
John W. Spellman	Associate	+1.310.788.4524	john.spellman@katten.com

NEW YORK

Ronni G. Davidowitz	New York Chair	+1.212.940.7197	ronni.davidowitz@katten.com
Mal L. Barasch	Of Counsel	+1.212.940.8801	mal.barasch@katten.com
Jason Benitez	Associate	+1.212.940.6498	jason.benitez@katten.com
Lawrence B. Buttenwieser	Of Counsel	+1.212.940.8560	lawrence.buttenwieser@katten.com
Jonathan C. Byer	Partner	+1.212.940.6532	jonathan.byer@katten.com
Bonnie Lynn Chmil	Partner	+1.212.940.6415	bonnie.chmil@katten.com
Alexandra Copell	Special Counsel	+1.212.940.8588	alexandra.copell@katten.com
Marla G. Franzese	Of Counsel	+1.212.940.8865	marla.franzese@katten.com
Robert E. Friedman	Of Counsel	+1.212.940.8744	robert.friedman@katten.com
Milton J. Kain	Of Counsel	+1.212.940.8750	milton.kain@katten.com
Dana B. Levine	Special Counsel	+1.212.940.6668	dana.levine@katten.com
Rebecca H. Lomazow	Associate	+1.212.940.6497	rebecca.lomazow@katten.com
Cynthia C. Reed	Associate	+1.212.940.6710	cynthia.reed@katten.com
Christina Romero	Associate	+1.212.940.6380	christina.romero@katten.com
Arnold I. Roth	Senior Counsel	+1.212.940.7040	arnold.roth@katten.com
Robert E. Smith	Senior Counsel	+1.212.940.8850	robert.smith@katten.com
Kathryn von Matthiessen	Partner	+1.212.940.8517	kathryn.vonmatthiessen@katten.com

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2021 Katten Muchin Rosenman LLP. All rights reserved.

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at katten.com/disclaimer.

9/24/21