Sanders Tax Proposal: Analysis and Suggestions for Immediate Action

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Introduction

On March 25, 2021, Senate Budget Committee Chairman Bernie Sanders (I-VT) fired the opening salvo in the debate over raising taxes by holding a hearing provocatively entitled "Ending a Rigged Tax Code: The Need to Make the Wealthiest People and Largest Corporations Pay Their Fair Share of Taxes." Sen. Sanders decried "the economic absurdity of two people in this country, Jeff Bezos and Elon Musk, owning more wealth than the bottom 40%" of American people and the "rigged and corrupt tax code that gives trillions of dollars in tax breaks to the wealthy and huge corporations."[1]

Sen. Sanders issued a lengthy preamble to the proposed legislation outlining the purposes of the For the 99.5% Act[2] (the "Act") enact a progressive estate tax that shifts wealth away from the top 0.5 percent in order to "create an economy that works for the remaining 99.5 percent." Notably, the Act is similar to an earlier iteration introduced in 2019 by Sen. Sanders aimed to shift wealth from the top 0.2% to the bottom 99.8 percent of the population.[3] While it is unclear whether wealth shifted or expanded over the past two years to account for this change, what has not changed is Sen. Sanders's laser focus on transforming the economy to address "income and wealth inequality."[4] The proposal by Senators Bernie Sanders (I-VT) and Sheldon Whitehouse (D-R.I.) was joined by Senators Chris Van Hollen (D-Md.), Jack Reed (D-R.I.) and Kirsten Gillibrand (D-N.Y.). Sen. Sanders reports that "companion estate tax legislation will be introduced [in the House of Representatives] by Rep. Jimmy Gomez (D-Calif.)."[5]

In any event, Sanders acknowledges that "there is not unanimity within the Democratic Caucus," as highlighted by the bruising defeat of the push for a $15 dollar minimum-wage hike during the most recent reconciliation fight in Congress when only 42 Democratic Senators voted for the increase.[6] Sen. Sanders views his job as Budget Committee Chairman "to rally the American people and to create a strategy…" to get the Act passed to "reshape the economy."[7] In a press release touting the Act, Sen. Sanders targeted specific wealthy families:

- The Walton family, the owners of Walmart, would pay up to $85.8 billion more in taxes on their $221.5 billion fortune.
- The family of Jeff Bezos, the founder of Amazon, would pay up to $44.4 billion more in taxes on his $178 billion fortune.
- The family of Elon Musk would pay up to $40.4 billion more in taxes on his $162 billion fortune.

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[1] Ending a Rigged Tax Code, 117th Cong (2021).
[2] For the 99.5% Act, S. 994, 117th Cong. (2021), available: https://www.sanders.senate.gov/wp-content/uploads/For-the-99.5-Act-Text.pdf.
[3] For the 99.8 Percent Act, S. 309 116th Cong. (2019).
[4] Kelsey Snell, *Sen. Bernie Sanders' Next Progressive Frontier: Reshaping a 'Rigged' Tax System*, NPR (Mar. 25, 2021, 5:00 am), https://www.npr.org/2021/03/25/980778465/sen-bernie-sanders-next-progressive-frontier-reshaping-a-rigged-tax-system.
[5] Press release by Sen. Bernie Sanders (I-VT), available: https://www.sanders.senate.gov/press-releases/sanders-and-colleagues-introduce-legislation-to-end-rigged-tax-code-as-inequality-increases/.
[6] Snell, *supra* note 4.
[7] Id.

- Facebook CEO Mark Zuckerberg's family would pay up to $25.3 billion more in taxes on his $101.7 billion fortune.[8]

Sen. Sanders goes through great pains to outline the net worth of "all 657 billionaires in America" and determining that, together, they would "owe up to $2.7 trillion in estate taxes."[9] Unfortunately, the proposed legislation casts a much wider net and has the capacity to impact many planning clients who are unlikely ever to make Sen. Sanders's list. As will be discussed below, a family seeking to protect children by purchasing life insurance in a trust could face significant hurdles.

Clients Should Act Now

In a related move, U.S. Senator Chris Van Hollen (D-Md.), joined by Senators Cory Booker (D-N.J.), Bernie Sanders (I-Vt.), Sheldon Whitehouse (D-R.I.), and Elizabeth Warren (D-Mass.) announced a new proposal to close the stepped-up basis income tax loophole. Other bills have and will no doubt be proposed. But the theme is clear: a strong intent by a number in Congress to address tax increases. The message to advisers should be just as clear: encourage clients to take planning actions now while they can, but caution them about retroactivity risks and the risk that suggested planning may not succeed, depending on the changes enacted.

Reduction of the Exemption and Spike in the Estate Tax Rate

Perhaps, the most talked about change the Act would accomplish is a reduction in the unified credit for estate and gift taxes effectively slashing the exemption of $10 million, indexed for inflation to $11.7 million in 2021, and by increasing the estate and gift tax rate of 40 percent.

The Act would reduce the estate tax exemption from $11.7 million to $3.5 million and impose a progressive estate tax that ranges from 45% to 65%.[10] Despite what some in the media have suggested, the new estate tax exemption is not indexed for inflation.[11]

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[8] Press release, *supra* note 5.

[9] Id.

[10] The Act, *supra* note 2 at Section 2.

[11] Joint Committee on Taxation (March 24, 2021), scoring the For the 99.5 Act, available: https://www.sanders.senate.gov/wp-content/uploads/For-the-99.5-Act-JCT-Score.pdf. Proposed revision to Paragraph (3) of section 2010(c) of the Internal Revenue Code no longer includes subpart (B), which had previously provided the language allowing for an adjustment to the basic exclusion amount for inflation. That provision current reads as follows: "(B) Inflation adjustment In the case of any decedent dying in a calendar year after 2011, the dollar amount in subparagraph (A) shall be increased by an amount equal to— (i)such dollar amount, multiplied by (ii)the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "calendar year 2010" for "calendar year 2016" in subparagraph (A)(ii) thereof. If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the nearest multiple of $10,000."

For very high net worth clients, the exemptions are largely insignificant. Rather, the significant factor is the rate of transfer tax. Increasing from 40% to as much as 65% will have an impact on the tax cost, especially when coupled with the other restrictions that would be enacted as part of the Act. As steep as this incline from 40% to 65% may appear, Sen. Sanders has softened his approach from an earlier iteration that would have required an astounding 77% for estates over $1 billion. For perspective, that was the rate on estates above $10 million until 1977. It is curious that Senator Sanders would proffer a less aggressive tax now that he holds the coveted budget committee gavel in the Senate. Could it be that this somewhat moderated approach is the result of discussions among the Democratic caucus? If so, the softening of Senator Sanders' approach could be and could be a calculated step towards enactment.

By reducing the estate tax exemption and increasing the tax rates, the Act significantly impacts estates across the wealth spectrum, in many cases, assessing a tax where there had not been one due before. Following is a table showing how estate taxes will increase, depending upon the value of the taxable estate:

Estimated Taxable Estate	2021 Estate Tax under current law	Estate Tax under "For the 99.5%" Proposal	Proposed Tax Increase
$5 million	-	675,000	**675,000**
$7.5 million	-	1,800,000	**1,800,000**
$25 million	5,320,000	11,745,800	**6,425,800**
$60 million	19,320,000	29,745,800	**10,425,800**
$100 million	35,320,000	51,745,800	**16,425,800**
$2 billion	795,320,000	1,196,745,800	**401,425,800**

A reduction of the estate tax exemption from $11.7 million to $3.5 million, the rate that existed in 2009 will dramatically change the estate tax planning environment and substantially increase the number of estates subject to estate tax. Millions of clients who have ignored the estate tax for years will have to rethink their planning and documents to address estate tax planning and to do so under the new regime that may be enacted. Many of these clients should consider taking immediate action to plan before the enactment of the Act or similar legislation.

The proposed $3.5 million exemption would greatly reduce the ability of wealthy clients to shift wealth out of their estates or into protective structures that may limit the reach of divorcing spouses or claimants. This might mean that there is a great advantage for clients to using the current $11.7 million exemption now, or as much of it as possible, before a change is enacted. Clients of moderate wealth ("moderate" relative to the current exemption amount) may wish to consider making simple gifts before the end of 2021 to a trust to accomplish asset protection, estate tax planning, succession planning and other objectives. Those gifts, to a GST exempt grantor trust, as will be discussed below, may secure grandfathering some valuable current tax benefits that will no longer be available after enactment. The Act curtails many of the wealth transfer strategies clients might need to use in order to avoid costly and complex planning once a new law is enacted.

Pre- and Post-Enactment Planning

Practitioners need to consider planning steps to discuss with clients prior to enactment, and separately planning steps to discuss with clients after enactment. While it is certainly important to consider the long-term implications of the Act on planning, practitioners should help clients focus in particular on planning steps to take prior to the various effective dates contained in the Act now. Different planning steps will be required for future action after enactment. For example, it may be possible for a moderate wealth client to create a traditional and relatively simple irrevocable life insurance trust ("ILIT") today and fund it with sufficient cash to pay premiums for years to come. If that ILIT is created after the various effective dates contained in the Act then the assets of that grantor trust, primarily life insurance, will be included in the client's estate defeating the primary objective of the plan (removing life insurance proceeds from the estate). Also, if the client does not fund the ILIT now the cap on annual gifts, discussed below, may inhibit planning. If the Act is passed, then practitioners, after its effective dates, will have to focus on new planning techniques for owning life insurance, but that planning should not detract from valuable planning that should be undertaken today. Some consideration will have to be given to creating ILITs that are not grantor trusts. An Obama administration proposal exempted ILITs and some other trusts but those exclusions have not found their way into the Sanders bill.

It has been a common practice to transfer assets to a Domestic Asset Protection Trust ("DAPT") before marriage to backstop a prenuptial agreement. That type of planning would have to rely on non-gift transfers (e.g., transfers to an incomplete gift trust that may provide asset protection, but which do not require the use of exemption), for any amount that exceeds the lifetime gift exclusion of $1 million or else such planning may no longer be feasible with such a low gift exemption.

Illustration of the Value of 2021 Planning Prior to Enactment

In order to illustrate how much this proposal would raise the federal estate tax, consider a married couple where each spouse owns approximately $16.5 million worth of assets, for a total marital estate worth $33 million.

Assumptions for each of the following two scenarios:

- Enactment of the "For the 99.5% Act" in its current form, generally effective as of 1/1/2022 (but caution is in order as many of the provisions in the Act are effective as of the date of enactment)
- Moderate 4% annual growth of the assets
- Death of first spouse occurs in 2022
- Death of survivor spouse occurs in 2023
- No taxable gifts prior to 1/1/2021
- Each estate pays about $100,000 in deductible administration expenses

Scenario 1: The spouses use very simple planning. Each spouse has a will that establishes an credit shelter trust equal to the federal exemption, with balance to surviving spouse on death of first spouse. The surviving spouse leaves his or her estate to their children in equal shares.

On death, the first spouse's estate would be worth approximately $17.16 million. A credit shelter trust would be funded with $3.5 million. There would be no federal estate tax on the death of the first spouse. The surviving spouse would therefore have a gross estate at the end of 2022 worth $30.7 million, with $3.5 million of that in the credit shelter trust.

Assuming that the surviving spouse's estate continued to grow at 4%, the surviving spouse would have a gross estate worth approximately $31.95 million on death. Only $3.5 million would be exempt from estate tax, so the estate would pay approximately $13.86 million in federal estate taxes, leaving $17.5 million of wealth to the family, including the amount available in the credit shelter trust.

Scenario 2: The spouses undertake aggressive planning in 2021 and each transfers assets to use their full lifetime exemptions of $11.7 million (it is assumed that is not too large a portion of their estate to transfer from a fraudulent conveyance perspective). On the death of the first spouse, the remaining estate is left to the surviving spouse who leaves the balance on his or her later death to the children in equal shares. If those shares are left in trust, which had been a common approach to planning for heirs, the new GST restrictions discussed below would apply to those trusts. That rule cannot be avoided by quick planning action. This is discussed below.

On the death of the first spouse, the value of each spouse's estate would be around $5 million. After expenses of administration, the value of the surviving spouse's gross estate would be approximately $9.9 million. Assuming moderate growth of 4%, the gross estate on the death of the surviving spouse would be about $10.3 million. Federal estate tax of $4.35 million would be due.

In the meantime, assuming the same moderate growth rate, the value in the trusts would be approximately $25.3 million. Thus, in the second scenario, the remaining balance to the family including the assets in the trusts would be $31.17 million. Simple trust planning in 2021 could save the couple's wealth over $13.6 million in federal estate taxes. It may also grandfather grantor trust status without causing estate inclusion, as discussed below.

Upstream planning is another topic that may deserve attention prior to any changes in the law. Any upstream planning that may have been done in the wake of enactment of the 2017 tax legislation should be evaluated.[12] Upstream planning was used to salvage otherwise unusable exemptions that elderly relatives of clients have. For example, if a parent has an estate of only $4 million, an adult child might have created a trust with $7 million and give parent a general power of appointment ("GPOA") over that trust. The GPOA could require the consent of a non-adverse party, could be crafted as a limited power of appointment and someone could hold the right to convert it to a GPOA, etc. The intent of the plan was that parent's estate would include the assets in the trust and those assets would obtain an estate tax free adjustment (hopefully step-up) in income tax basis on parent's death. If the exemption is reduced to the $3.5 million as in the Act, most or all upstream planning would be obviated.

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[12] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018., H.R. 1, 115th Cong. (2017), Pub. L. 115-97, available: https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf

If that occurs, practitioners might want to review that planning to be certain that the estate inclusion in the upstream plan does not inadvertently trigger an unintended estate tax on the senior generation's death. While many such upstream plans were likely crafted to only include in the senior generation's estate an amount that would not trigger an estate tax, the more prudent course of action would be to confirm that and make any modifications as may be necessary.

In order to effect upstream planning, the younger generation must transfer wealth to the senior one. That may well result in gift taxation to the younger generation unless a plan to transfer wealth to the more senior generation occurs without gift tax as it might with a GRAT. However, the time to do that and still garner the benefits of the larger exemptions the senior family members have may soon be foreclosed.

Considerations for Post-Enactment Planning

While the planners and particularly clients have mostly enjoyed an estate tax exemption exceeding $5 million for the past decade, the exemption was $3.5 million in 2009 which was not too long ago. In 2009, a common practice was for married couples to fund a credit shelter trust up to the largest amount that would not generate a state or federal estate tax. As the exemption grew, the default plan for some married couples evolved. QTIP trust planning became more common, wherein the surviving spouse would have the right to disclaim into a family trust, or perhaps gave an independent executor the right to elect the portion of the QTIP qualifying for the marital deduction thereby shifting funds to a credit shelter trust (the Clayton QTIP approach). A reduction in the exemption to a $3.5 million level might suggest that reverting back to this historic credit shelter default plan may prove better for some clients. A key point I that all estate planning documents will have to be reviewed if the Act is passed. Note that the Clayton QTIP approach is not apparently available for gift tax purposes.

As the federal tax exemption increased dramatically over the past ten years, some states adjusted their estate taxing regimes to increase exemptions as well. To the extent that the federal exemption is reduced to $3.5 million and if a state does modify its own tax code "quickly" enough, the federal exemption might be the lower of the two exemptions to which an estate is subject.

- A common drafting technique is to fund a credit shelter trust at the lesser of the state or federal exemption amount. If the federal exemption amount is reduced to $3.5 million and a state does not quickly adjust their laws, the federal exemption might be the factor which limits the use of the state estate tax exemption. This quandary harkens back to the creation of the state-only QTIP so that a trust could be funded up to the higher federal exemption amount. Will necessity soon invent the federal-only QTIP that is to be treated as a state credit shelter (not marital trust) so that the trust may be funded with and secure a higher state exemption amount. The legality of a testamentary state-only QTIP/federal credit shelter trust will depend on a state-by-state analysis and require significant revisions to wills that would allow for its creation. Even to the extent that such an option was to exist, it may not be available for any significant period of time as states are also struggling financially from the pandemic's economic restrictions and may match any federal government in reduction in estate tax exemptions. Practitioners who may draft to create a state only credit shelter in a will or revocable trusts should consider adding a mechanism to modify that bequest if state law catches up and reduces its exemption to match the lower federal exemption. In particular, practitioners may wish to review "Quadpartite Will Redux: Coping with the Effects of Decoupling," 32 Estate Planning 15 (October 2005).

A Different Gift Exclusion

The Act modifies the gift tax exclusion amount by pulling it apart from the estate tax basic exclusion and reducing it to $1 million.[13] Notably, the gift exclusion is also not indexed for inflation, thereby capping the ability of modest clients to accomplish gifting prior to death.

This proposed $1 million gift tax exclusion would dramatically alter not only gift tax planning but could affect asset protection and divorce planning as well. If the gift exemption were reduced to $1 million, the ability of clients to leverage wealth out of their estates, to implement asset protection planning, to safeguard assets for matrimonial purposes, etc. could all be hindered. For example, a physician with several millions of dollars of non-pension assets would be precluded from transferring those assets to a trust to provide asset protection planning, since any transfer exceeding $1 million would trigger gift tax, unless the transfer is to an incomplete gift trust.

Using Current Exemptions - A Short Window of Opportunity

Section 2 of the Act is effective for gifts made after December 31, 2021, providing a tremendous albeit short window of planning opportunity to complete planning to use exemptions in 2021. With a current gift and GST exemption of $11.7 million and a potential reduction of gift exemption in 2022 to only $1 million, it is hard to conceive of many clients who should not create trusts, notwithstanding the limitations of those trusts under the Act, if enacted, and use as much remaining exemption as feasible. But there are several important planning considerations to exemption use. Of course, many property owners will be hesitant to transfer significant wealth which they believe they may need to maintain their lifestyles.

Even, unrelated to tax planning, moderate wealth clients might consider having their wealth adviser and/or CPA prepare a budget and financial projections so that the client can determine the extent to which they are comfortable making the transfers and will not face undue financial worries as a result. A second and related analysis is to demonstrate that post-transfer the clients can meet their ongoing lifestyle and other expenses so that a fraudulent conveyance challenge can be deflected. It is not clear in such an analysis what access to transferred assets should be factored into the calculations. For example, if the client is creating a special power of appointment trust ("SPAT") factoring in an assumption of certain distributions by exercise of that power might be argued to suggest an implied agreement to make distributions. (See "SPATs: A Flexible Asset Protection Alternative to DAPTs," 46 Estate Planning 3 (Feb. 2019).) So, caution is in order and consideration should be given to the nuances of the planning in creating an analysis to support transfers of a large percentage of wealth.

By setting forth an effective date that does not begin until January 1, 2022, the Act removes the worry that had plagued planners at the end of 2020 and beginning of 2021, that somehow Congress would enact legislation that upon signing would reduce exemptions retroactively to January 1, 2021. With a

[13] The Act, *supra* note 2, at Section 2.

risk of retroactivity reduced, can practitioners ignore prior discussion of using formula clauses in transfer documents and disclaimer provisions in trusts when planning? While it would appear that, perhaps, there may no longer be a need for cautious disclaimer and formula clauses in 2021 planning documents, that could be a risky gambit that clients should decide upon. There is absolutely no certainty as to what might ultimately be enacted, or its effective date. Some clients might still prefer to incur the additional cost and complexity of integrating adjustment mechanisms to address the risk of retroactivity.

Another consideration is very important. If the Act were to become law relying on the December 31, 2021 date to make transfers to use exemption could be a terrible mistake. Other provisions of the act, such as those affecting inclusion in the settlor's estate of grantor trust assets, apply to trusts created after enactment, not created after the effective date of the act. Therefore, practitioners really should advise clients to plan as quickly as possible as the effective dates cannot be known. Relying on a year end date may be a material disadvantage to the planning that may remain feasible.

Forever on the Chopping Block: Valuation Discounts

Remember the panic over the proposed 2704 Regulations? Well, as Yogi Berra said, "It's like déjà vu all over again. "The Act takes direct and deadly aim at the heart of valuation discounts for "nonbusiness assets" which is defined to mean "any asset which is not used in the active conduct of 1 or more trades or businesses."[14] In addressing valuation discounts, the Act targets minority discounts with specificity, disallowing any discounts "by reason of the fact that the transferee does not have control of such entity, or by reason of the lack of marketability of the interest" in cases where "the transferor, transferee and members of the family (1) have control of such entity, or (2) own the majority of the ownership interests (by value) in such entity."[15] By particularly identifying marketability and lack of control discounts, the Act appears to leave intact other types of discounts such as a blockage or saturation discount.

Example: Client wants to make a gift of her interests in real estate LLCs that own neighborhood shopping centers. Client's interest in the LLCs is restricted by operating agreements that limit her ability to sell her interests or control the entities.

Because these are non-controlling interests under current law, a valuation professional determines that her interest in the entities is worth a little more than $11 million, determined as follows:

[14] The Act, *supra* note 2 at Sec. 6.
[15] Id.

Gross Asset Value		16,000,000
Less Discount for Lack of Marketability	28%	(4,400,000)
Value of Non-Marketable Interest		11,600,000
Less Lack of Control Discount	5%	(580,000)
Fair market value of Non-Marketable, Non-Controlling Interest:		**11,020,000**

Using her current lifetime gift exemption of $11.7 million, the client might be able to gift all these interests to a trust for descendants. The issue of discounts has a long history, with taxpayers and the Service battling in multiple high-profile cases. Ultimately, the Courts have mostly sided with taxpayers who have argued that the fair market value must reflect the reality that minority interests cannot be used to control the entity and are not readily marketable. The Act undoes all of that jurisprudence with the stroke of a pen, all but eliminating minority discounts for so-called nonbusiness assets.

In this example, the interests that the Client owned would be valued, post-enactment at both a gross and net value of $16 million under the Act, notwithstanding her inability to sell or exercise any control over the interests.

These provisions of the Act indiscriminately attack discounts based on the use of the asset, without consideration for the actual nature of the asset. It abandons the concept of fair market value as "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."[16]

Indeed, it is far different to give away one-third of a portfolio than it is to give away one-third of a house; yet generally the Act recognizes no such distinction. In both cases, the value for gift purposes would be the gross value of the entire asset times the percentage in It that is transferred. This simple arithmetic turns a blind eye to the realities of co-ownership of an asset that cannot be split easily into fractional shares.

The Act addresses valuation discounts for non-controlling positions in an entity on assets that are deemed "non-business" even within an operating company. That is to say, the Act appears to suggest that non-business assets are valued without discount, but to avoid duplication, the entity is valued without the inclusion of such assets. In this way, the Act appears poised to usher in a new regime of valuation analysis whereby professionals will need to identify all of the assets of an entity and then categorize them as either "business" (and therefore eligible for certain discounts) and "nonbusiness" (discounts do not apply). Conceptually, the final value determined under the Act would be a discounted value of the business interests plus the non-discounted value of the pro-rata interests in non-business

[16] Treas. Reg. Sec. 20.2031-1(b).

assets. Note, however, that a similar provision has been in Section 6166(b)(9) relating to the deferral of payment of estate tax on certain business interests for decades.

Example: The gross value of the active business operations of an entity are worth $6.5 million. A qualified valuation professional concludes that the appropriate discount is 30%. The same entity holds $450k worth of marketable securities. None of the marketable securities are considered "business" assets. The owner seeks to make a gift of a 20% interest in the entity to an adult child, which has a value as determined under the Act of $1 million, as follows:

Gross Asset Value of Business Assets	**6,500,000**
20% of the Gross Asset Value of the Business Assets:	**1,300,000**
Less: 30% Valuation Discount	**(390,000)**
20% of Gross Asset Value of Non Business Assets	**90,000**
Total value of interest conveyed:	**1,000,000**

The Act specifically carves out an exception for the "working capital reasonably required" for the operation of a trade or business, though it does not define how a business owner might demonstrate how to meet the standard. (Again, this is the same as the provision in Section 6166(b)(9).) Arguably, the business owner could refer to the type of analysis used to avoid personal holding company ("PHC") penalties, though that is far from clear from the face of the proposed Act. Practitioners may find that each year an analysis will need to be completed to determine the potential fund reasonably required by the business, followed by minutes of the board (or a consent of managers for an LLC) documenting the working capital needs of the busines. While it is not yet clear what will suffice, small businesses that lack the internal infrastructure and sophisticated advisors to produce such records. Ultimately, the risks and complexity of this may outweigh the benefits of any valuation discounts that might be realized.

Additionally, the Act would create specific "look-through" rules to prevent tiers of entities that might circumvent these restrictions on discounts of non-business assets.

Example: Assume passive real estate is deemed a non-business asset because the client does not materially participate in accordance with the requirements of IRC Sec 469 and related regulations.

Where a Client wishes to transfer 20% of the real estate interests to an heir (or trust for an heir), the planning professional may have recommended using a family real estate holding entity to make the transfer. Such a transfer would likely have qualified for a discount of around 35% (more or less, depending on the facts and circumstances).

Under the Act, the asset will have to be valued as if transferred directly. However, it appears that discounts inherent to the asset itself may apply. In other words, if the entity owned interests in warehouses in the particular county and the family interests had such a substantial interest in warehouses in that county that it could take, by the estimate of a real estate appraiser, 15 years to sell all of their interests, an absorption discount may still apply.

Restrictions on valuation discounts only apply if an entity is controlled by a member of the same family, as that term is defined to mean an ancestor, spouse, lineal descendant of such individual, the individual's spouse or a parent, or the spouse of any lineal descendant.[17] While it is not likely that the Act would apply to conglomerates of different families joining together to enjoy discounts as they had before, there does appear to be some opportunity for closely knit family friends to take advantage of valuation discounts in planning. Perhaps, a new "marriage penalty" would be the loss of discounts on transfers between families.

Grantor Retained Annuity Trusts (GRATs")

One Last Bite at the GRAT Apple?

As it relates to GRAT (grantor retained annuity trust described in Reg. 25.2702-3) restrictions, the Act applies to transfers made after the date of the enactment (not the effective date of the Act which could be January 1, 2022). Commentators expect that enactment of the next tax bill could occur as earlier as July 2021 but more likely will not happen until sometime in October 2021. But there is no certainty as to any of that and the Act might be appended to an infrastructure bill and pass into law much sooner. Clients may have one last opportunity to use GRATs in order to leverage wealth out of their estates but only if they act quickly in the next few months.

Several of the concepts that practitioners might want to consider for application of GRATs before enactment might include using a long-term, perhaps 99-year GRAT to potentially leverage large values outside the estate. This is really an interest play and if the rates of interest increase significantly between the date the GRAT is completed and the settlor dying as only a portion (and, perhaps, only a small portion) of the GRAT corpus will be included in the estate. Another approach might be to create a tiers of GRATs now to lock in the GRAT benefits, still historically low interest rates, etc. This might be beneficial since GRATs, as explained below, may not be feasible after enactment. So, depending on age and health, a client might create a ladder of a 6, 8, 10 a 12-year GRATs. If there is a concern about mortality risk so some of the GRATs fail, life insurance in an ILIT might be used to negate that cost. Finally, a GRAT or tiers of GRATs may be made payable to a non-GST life insurance trust to fund the ILIT in light of proposed limitations on the amount annual gifts exclusions allowed.

GRATs Post-Act

Practitioners must also consider the range of other "restrictions" proposed in the Act on GRATs. Sec. 7 of the Act proposes limits on the use of a Grantor Retained Annuity Trust described in Reg. 25.2701-2,, a planning tool long favored by some planners. A key benefit of GRATs is that clients can create these trusts to shift wealth out of their estates without using any significant gift tax exemption or, if not

[17] IRC Sec. 2032A(e)(2).

exemption is left, without significant gift tax. To the extent the assets in the trust grow at a rate above the Section 7520 rate used to value the annuity stream in the trust or its remainder, that excess will be shifted outside the estate. Many, perhaps most, GRATs were structured by practitioners as so-called "zeroed-out GRATs." Specifically, a zeroed-out GRAT is structured so that the present value of all annuity payments required to be made from the trust to the grantor equaled (or almost equaled) the value of assets transferred to the GRAT. Some practitioners preferred to have a modest gift value to report on a gift tax return.

Upside appreciation in the trust above the rate of return (Section 7520 rate) would inure to the beneficiaries of the GRAT with no gift tax cost. The Act seeks to undermine the viability of the GRAT technique by requiring a minimum 10-year term for any GRATs created after the enactment of the Act. The imposition of a ten-year requirement would dramatically reduce the efficacy of a GRAT for some clients because if a client does not outlive the term of the GRAT, some or all the assets (generally) are included in the client's estate.

While the mortality risk of a ten-year GRAT may be offset with life insurance, the Act Sec. 7 imposes another significant restriction on GRATs that may signal the death knell for this popular technique: a minimum gift amount. In other words, zeroed-out GRATs will no longer be permitted and a transfer to a GRAT must result in a remainder interest gift amount "determined as of the time of the transfer, which is not less than an amount equal to the greater of 25% of the fair market value of the property in the trust or $500,000."[18] A fundamental aspect of GRAT planning was to be able to make transfers that used only a nominal amount of exemption. This change alone will make many planned GRATs ineffectual tools after enactment unless a new application of the technique is possible. Also, consider this change in the context of a $1 million gift exemption. In other words, unless the gift of the remainder is below the grantor's gift tax exemption, gift tax will be due with no assurance that any wealth will be transferred to the beneficiaries (other than the grantor).

These two changes could make GRATs impractical for wealthy taxpayers that have used GRATs when they no longer had gift tax exemption remaining. The Act eliminates the commonly used technique of "rolling-GRATs", where practitioners would create a 2-year GRAT, and the client would "re-GRAT" each annuity payment received to a new GRAT and attempt to continue to shift appreciation above the Sec. 7520 rate.

If GRATs, discounts, and other techniques are also "closed down" as proposed in the Act, the ability to plan around a $1 million exemption will be more limited than it had been in the past years when the $1 million exemption was law. In the past, discounted FLP interests inside GRATs, rolling GRATs, etc. all facilitated wealth transfers "around" the low $1 million exemption. If changes as sweeping as has been proposed under the Act are enacted, the prior tools for addressing a low exemption will largely not be available.

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[18] The Act, *supra* note 2, at Sec. 7.

Grantor Trusts

Grantor trusts have been at the foundation of many estate planning techniques for decades. That all may change if the Act becomes law. The planning steps to discuss with clients prior to enactment are quite different than those that might become necessary after enactment.

Grantor Trusts Pre-Act

Under current law, and until the date of enactment, clients can create grantor trusts and transfer assets to them to use their exemption or to consummate sale of assets to the trust in exchange for a note (a so-called "note sale transaction). Post-enactment, as explained below in more detail, new grantor trusts, or existing grantor trusts to which additional assets are transferred, will be included in the settlor's estate (see detailed discussion below). This may make it very important for some clients to create and fund grantor trusts prior to the date of enactment. In fact, for some clients, creating and funding the grantor trust may be more valuable than just the use of exemption. Also, because the use of the current high exemption is permitted under the Act until December 31, 2021, some clients may be confused to focusing on that as the operative date when in fact the date of enactment, which could be at any time, is the governing deadline. To whom other than a grantor trust should client's gift large remaining exemption amounts? Post-enactment that will not be possible. Practitioners should be careful to communicate this subtle point to clients. And note there may be even more limited "grandfathering" for grantor trusts described in Section 678 (sometimes call BDITs or variants call BDOTs.)

Grantor Trusts Post-Act

In a direct assault on the foundation of modern estate planning, the Act Sec. 8 creates "Special Rules for Grantor Trusts" that will require the assets of certain grantor trusts, described in dealt with primarily in Section 671 to 679,to be included in the estate of the settlor. Since completed gift grantor trusts have been a foundation for much of recent estate planning for years, these new rules will have a significant and adverse impact on planning. In short, the Act would include in a client's gross estate the value of those assets owned by grantor trusts reduced only by taxable gifts made to the trust.

Grantor-type trusts are those trusts whose income is taxed to the settlor creating the trust (or to certain persons deemed to be the owner of the trust under Section 678) . Additionally, sales to the Beneficiary Defective Inheritor's Trust (BDITs) are specifically targeted, requiring inclusion of some portion of the asset in a trust over which a person, other than the settlor of the trust, is deemed the owner for income tax purposes, to the extent that such a person engages in a "sale, exchange or comparable transaction" with the trust.[19]

As a matter of current law, the income tax characterization as a grantor-type trust permits a settlor, or person who is treated as the owner for income tax purposes, to buy or sell appreciated assets to and from the trust without causing gain recognition. In addition, the creator of the trust will report any income attributable to the trust on his or her own tax return, therefore paying the income tax on trust income, permitting greater growth of wealth inside the trust. This also simultaneously reduces the

[19] The Act, *supra* note 2 at Sec. 8.

settlor's taxable estate because the IRS has conceded that the grantor paying income tax on the trust's income attributed to him or her is not a gift. See Rev. Rul. 2004-64. In fact, over a long-term period, the income tax shifting can be the most valuable of all estate tax benefits. It also permits the client to sell assets to the trust without recognition of gain due to that sale and shift growth outside the grantor's estate. These sales, often done for a note issued by the trust, have been a mainstay of planning in the estate planner's arsenal.

As written, the Act would require an estate to include the value of assets owned by a grantor-type trust established after enactment of the Act, less any taxable gifts to the trust made by the owner. The exclusion of taxable gifts avoids duplication or doubling of tax. If a gift is made to a grantor trust post-enactment, e.g., $1 million. That grows to $2.5 million. When the owner dies, the entirety of the trust corpus of $2.5 million is included in the settlor' taxable estate and a reduction for the $1 million previously given is available. The result, however, is that all appreciation is included in the settlor's estate, thereby defeating any planning benefit. If instead the initial gift had been made to a non-grantor trust, inclusion might be avoided. The Act is an effort to eliminate the benefit of the "tax burn" enjoyed by grantor trusts, that is, the payment of the income taxes by the grantor on income earned by the trust. It also would eliminate for new trusts the ability to have a swap power because a non-grantor trust cannot engage in a swap, and a new grantor trust will be impractical to use in many instances as it will not remove assets from the settlor's estate.

There have been four key tax benefits that have been the focus of much of estate planning: 1) Removal of future appreciation from the client's estate which this new rule restricts for post-Act transfers to grantor trusts; 2) locking in valuation discounts which have also been restricted; and 3) "burning" the client's estate by the client paying the income tax cost on income earned by an irrevocable trust that is outside the client's estate; and 4) grow assets inside dynastic trusts for as long as feasible. This new grantor trust rule eliminates two of these four benefits and another provision of the Act eliminates the third and restricts the fourth.

Non-Grantor Trust May Receive Increased Use but Be Careful

As explained above, post-enactment, clients will have to consider the viability of using new non-grantor trusts, since the use of new grantor trusts will not result in the removal of assets from the settlor's estate. In a separate, seemingly unrelated, development, the IRS has included incomplete gift trusts ("INGs") in its annual no-rule list, indicating that it will not issue letter rulings until it reaches some resolution on outstanding concerns through future guidance.[20] By including INGs on this odious list, the Service is sending a signal that "these strategies could be challenged in the future," causing some trepidation among the planning community.[21] This may prove particularly concerning post-Act if clients have to shift planning to non-grantor trusts to avoid the estate inclusion rules that may become applicable to grantor trusts.

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[20] *See* Rev. Proc. 2021-3, 2021-1 IRB 140.

[21] *Incomplete Gift Trusts Hit IRS's No-Rule List in Foreboding Move* (Mar. 22, 2021), available: https://www.taxnotes.com/tax-notes-today-federal/trusts-and-estates-taxation/incomplete-gift-trusts-hit-irss-no-rule-list-foreboding-move/2021/03/22/3th7q, quoting Justin Miller of BNY Mellon.

With the IRS reversing its position on ING trusts, the Act's reduction of the gift exclusion to $1 million could make asset protection extremely difficult.

Another issue that will become more nettlesome if grantor trusts are used more commonly in planning is assuring S corporation status for trusts that will hold S corporation stock. Grantor trust were easy to use in the context of S corporation planning as a grantor trust will qualify as an S corporation shareholder. A non-grantor trust must meet the rules of a Qualifying Subchapter S Trust ("QSST") or an electing small business trust ("ESBT") in order to hold S corporation stock.

Life Insurance Trusts Pre-Act

Irrevocable life insurance trusts ("ILITs") have been one of the most common estate planning techniques for many years. The key objective of most ILITs has been to assure that the life insurance proceeds are excluded from the client's estate. The Act could upend this traditional planning tool used by many families for protection (e.g., protect the insurance proceeds if the surviving spouse remarries, etc.), not only by the wealthy. A number of different provisions of the Act could undermine this common planning tool and require estate planners and insurance consultants to revisit planning.

Life Insurance Trusts Pre-Act

Since under current law (i.e., prior to the date of enactment) clients can have assets held in grantor trusts without estate inclusion, the goal should be to assure that any client who might need an ILIT has a grantor ILIT created. In addition to preserving grantor trust status, which can be particularly useful for life insurance, the restrictions on annual gifts will have to be evaluated in light of most insurance plans. The typical insurance plan has relied on annual gifts, and issuances of annual demand or Crummey powers, to fund the insurance trust and then fund the payment of premiums. With the caps on annual gift exclusions to trusts, it may be advantageous to overfund an ILIT now using annual exclusion gifts and unused exemption so that the ILIT will have premium dollars for years to come. Another approach that may be viable for some clients is to shift the life insurance from an old style ILIT that had only a modest bank account and relied on annual gifts to fund premium costs, into a robust spousal lifetime access trust ("SLAT") or other irrevocable trust so that the large value of income producing assets can be used to fund insurance premiums without annual gifts. That might be accomplish by a decanting or merger of the old ILIT into the newer SLAT (be mindful of different GST exclusion ratios), or a sale of the policy from a grantor ILIT to a grantor SLAT. Another approach may be to create a tier of GRATs that pay over into the ILIT (assuming the ILIT is not GST exempt) as discussed above.

These special rules for grantor trusts become effective upon enactment of the Act, thereby providing a tremendous incentive without delay before the enactment of the new law. Planning now should not merely be about using exemption but also about avoiding the harsh impact of the new provisions causing inclusion in the settlor's estate of assets in a grantor trust.

Life Insurance Trusts Post-Act

Unfortunately, even modest taxpayers who set up insurance trusts after the enactment of the Act may suffer some collateral damage from the approach the Act takes to grantor trusts and annual gifts. This can be illustrated as follows:

Scenario: Divorced attorney with three children purchases a life insurance policy with a benefit amount of $5 million so that she can fund her children's education in the event of her untimely death. She creates a standard life insurance trust (ILIT) using a template that she found online in early 2022, after the enactment of the Act. She dies after paying approximately $240,000 in life insurance premiums.

She has a modest lifestyle and manages to accumulate assets with a value of $3.3 million as of the date of her death, with no debt as of the date of her death.

Pursuant to IRC Sec. 677(a)(3), the life insurance trust is a grantor trust because her trustee had the power, without the approval or consent of any adverse party, to apply income of the trust to the payment of premiums on policies of life insurance on her life. Thus, the Act would appear to require her estate to include value of $4,760,000 in her taxable estate ($5 million less the premiums paid). As a result, it would seem that the Act would require the estate to pay federal estate taxes of $2,052,000 assuming none of the $3.5 million estate tax exemption is available. The Act would require the trust to pay the estate taxes attributable to the assets of the trust (insurance proceeds) included in her gross estate, rather than reduce the assets in the estate. Under prior law there would have been no estate tax due as the result of her use of a relatively simple and common ILIT. No longer.

ILIT Planning Considerations

Option 1 – Plan Now: Fortunately, grantor trusts (including ILITs) that are established prior to the enactment of the Act will not suffer from this terrible result (although new additions to the trust are not grandfathered). Anyone considering this type of planning should complete it now while the current law is still in force. This is discussed above.

Option 2 – Structure Post-Enactment ILITs To Mitigate the Harsh new Rules: Insurance trusts can be viable after the enactment of the Act, so long as they are structured carefully:

- Consider making the ILIT a nongrantor trust by requiring an adverse party to consent to the payment of premiums from the income or principal of the trust and distributions from the trust to the grantor's spouse (and any other provision that would trigger grantor trust status).
- Make gifts outright to beneficiaries who can then loan the funds immediately to the trust. Perhaps, these loans might be structured as split-dollar insurance loans described in Reg. 1.7872-15 to avoid any need to make current interest payments. Alternatively, the settlor might make split dollar loans to the ILIT.
- Exercise considerable caution in any transactions with the trust since the "tax" safety of a grantor trust will not exist. Thus, the client will not be able to sell insurance to the trust to avoid the 3-year estate inclusion rule of Section 2035 on a gift of a policy to the trust. (Even that gift will have to run the gauntlet of lower annual gift exclusions and the lower lifetime gift exemption). The ILIT will not be able to sell a policy to another trust without potentially triggering gain.

Option 3 – Use Other Structures: A family limited partnership (FLP) or limited liability company (LLC) might own a life insurance policy on the life of an individual, say a parent. The children might own the partnership or membership interests. Perhaps, a small 1% interest in the FLP or LLC could be owned by a trust that could control distributions and liquidation decisions, analogous to the approach some practitioners have employed to deflect a *Powell* challenge. If annual gifts are made to the heirs and they recapitalize the entity each year to fund insurance premiums it might avoid the new cap on annual gifts to trusts and of interests in entities. Using the FLP/LLC structure will provide asset protection and centralized management. The individual the client would have named as trustee of the ILIT might be named as the general partner or manager of the FLP/LLC. Perhaps the heirs that receive annual gifts directly might have their FLP/LLC interests owned by a trust they create using some portion of their 1-million gift exemption.

Change Durable Powers of Attorney to Permit ILIT funding/Loans

Practitioners should review client's durable powers of attorney in light of the various Act restrictions, especially on annual gifts. If the client is disabled and the agent under the power of attorney takes over for the client's financial matters, will the agent have authority to continue to fund the life insurance plan to allows for contributions to an entity so that the entity will have sufficient resources to pay premiums on the life insurance policy?

Post-Act Inadvertent Contributions to a Grantor Trust

The Act imposes these new special rules to that portion of any grantor trust "attributable to a contribution made on or after [enactment]."[22] Thus, future planning may be complicated as practitioners will have to discern when trusts were created, whether additional contributions were made post-effective date of the Act, and whether or to what extent the new law applies. Interestingly, the Act uses the term "contribution" in this section (2). To the extent that a grantor trust is established prior to enactment of the Act, would a grantor still be able to sell an asset to a grantor trust without implicating the Act? If a sale is not considered a contribution for these purposes, it would seem that may be possible to use older grantor trusts to which no new gift transfers are made after enactment to accomplish an estate tax freeze using a sales transaction. But a gift component to a transfer could not only trigger an inadvertent gift tax (and remember the lowered gift exemption) but would cause a portion of the trust to be included in the settlor's estate as well.

Extreme caution must be exercised with older trusts executed prior to enactment. Despite the planner's best intentions, clients may unknowingly trip the wires that would implicate the Act's special rules, as in the following:

<u>Example</u>: Settlor creates a trust in 2020 and believes that no later additions are made. However, Settlor each year pays the institutional trustee fee of $10,000/year directly and pays the accountant's fee for trust income tax filings and related accounting work of $5,000 directly. These indirect gifts continue for 10 years before the Settlor dies. Following enactment of the Act, Following enactment of the Act, this practice continues eight more times, resulting in contributions of approximately $120,000 to the trust. As a result, the Act would seem to require the executor of the Settlor's will to analyze how much of the value of the trust corpus is included based on a fraction where the value of the contributions made to the trust is the numerator and the total value of all contributions made since inception is the

[22] Id. at Sec. 8.

denominator. The analysis may be akin to that done in a matrimonial matter to determine the impact of commingled funds.

A Possible Replacement for Grantor Trusts?

Post-enactment, perhaps FLPs and LLCs and other structures might be used instead of what is, under present law, handled in grantor trusts in order to achieve asset protection objectives for the family. In some of these structures, a 1% general partnership interest might be owned by a trust with the 99% nonvoting interests owned outright by various family members. A restrictive operating agreement may inhibit access to the underlying investments by the creditors of the individual owners but it would not seem to foreclose the attachment of the ownership interest in the partnership itself unlike a trust where the beneficiary's interest in a spendthrift trust usually cannot be attached.

Non-grantor trusts will likely reappear as a more necessary approach if the Act becomes law. This may occur because of the Act's including in the settlor's gross estate assets of a post-Act grantor trust (funded post-Act or created post-Act). A non-grantor trust differs from a grantor trust in that there is a hybrid approach to income taxability. Specifically, ordinary income earned by the trust from various sources, including interest, dividends, rental income, etc. may be retained by the trust or else distributed out to beneficiaries. To the extent income is distributed to a trust beneficiary, the trust will receive an income distributions deduction. Generally, capital gains and losses will remain within the trust and not be passed through to beneficiaries, though there are some exceptions.

The income tax rates for nongrantor trusts are severely compressed as compared to those applied to individuals. In 2021, nongrantor trusts will be taxed at the highest income tax rate (37% plus 3.8% net investment income tax, if it applies) on all income over $13,050. If the Biden administration raises marginal tax rates to 39.6% the rate the impact would be even greater. Nongrantor trusts may be taxable in states based on the laws of each state. Even though income taxes may be higher and reporting more cumbersome for non-grantor trusts, it may be more advantageous in the long run to use non-grantor trusts if the Act is ultimately passed in its current form.

Sales to non-grantor trusts have infrequently been used but may become a more popular planning tool in certain circumstances.

<u>Example:</u> there may be a planning opportunity following enactment using a sale to a nongrantor trust. Client's spouse died and interests in the family business received a step-up in income tax basis (since the Bill, at least in its current format, does not limit the step up in basis on death). Surviving spouse sells those interests to a non-grantor trust. While that trust will be subject to the new GST tax restrictions (inclusion ratio of 1) in year 50, the assets with all appreciation should be outside the client's estate.

Grantor Trusts and Basis Step-Ups

While the assets owned by the grantor trust that are included in the taxable estate would be stepped up to the date of death value, the Act proposes to codify the disallowance of a step-up in basis for property held in certain grantor trusts, to the extent of any amount that is not includable in the gross estate of the transferor.[23] Under current law some commentators have argued that appreciated assets in a grantor trust do receive a basis step up. See, in particular, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," Journal of Taxation 149 (Sept. 2002). The fact that Congress is considering a specific legislation prohibiting that position might be viewed by some as a tacit confirmation of the validity of that position.

Dynastic Planning and GST Dramatically Changed

Perhaps, no provision in the estate tax code engenders more derision than the generation skipping transfer tax (GST) exemption. According to Sen. Sanders, "[b]illionaires like Sheldon Adelson and the Walton family, who own the majority of Walmart's stock, have for decades manipulated the rules for trusts to pass fortunes from one generation to the next without paying estate or gift taxes."[24] For this reason, the Act seeks to strengthen the generation-skipping tax by requiring that, for any distribution from a new trust that is not a qualifying trust, "the inclusion ratio with respect to the property transferred in such transfer shall be 1."[25] A qualifying trust means "a trust for which the date of termination is not greater than 50 years after the date on which such trust is created."[26] For any trusts created before enactment, any such trust shall be considered a "qualifying trust" for a period of 50 years, starting on the date of enactment.[27]

Dynastic planning has been at the foundation of modern trust and estate planning. The goal had been to shift value to an irrevocable trust and allocate GST exemption to the trust. Properly done under the current system, the value of assets in that GST exempt trust, no matter how much they appreciate and no matter how long held in trust, might never be subject to the transfer taxation system. The compounding of wealth outside the estate tax system can provide incredible wealth shifting opportunities. When this is coupled with a long-term trust (dynastic trust) wealth can compound outside a client's estate forever. The Act seeks to limit the application of the GST exemption to a maximum of 50 years.

The scope of this provisions seems broad, and its application destroys traditional non-tax planning. An obvious reason to create long term trusts is to protect assets from divorce or an heir's divorce, from the litigious nature of society, etc. Yet, if assets are transferred in trust, they will be subject to a GST tax after 50 years thereby potentially reducing the value of the assets in an amount greater than the divorce threat the client is seeking to protect an heir against.

<u>Example</u>: Prior to enactment, a physician client in her late 30s is concerned about asset protection planning and safeguarding as much of the current exemption as possible. She created a self-settled domestic asset protection trust (DAPT) under current law. A primary goal was to grow assets outside her estate during the remainder of her career and safeguard those assets from malpractice claims so that she may be provided access to them to pay for her retirement. At ages 75-90 she draws funds from the DAPT for living expenses. There is no transfer tax, and she continues to pay income tax as the trust is a

[23] Id. at Sec. 5, *modifying* IRC Sec. 1014.
[24] Press release by Sen. Bernie Sanders (I-VT), *supra* note 5.
[25] The Act, *supra* note 2 at Sec. 9.
[26] Id.
[27] Id.

grantor trust. At age 91 she withdraws funds from the DAPT but since more than 50 years have passed the new GST rules under the Act appears to apply. However, there are no tax consequences because the distribution is to the settlor, who is not a skip person to which the GST tax does not apply. However, in the year, which is 50 years after the date of enactment, the trust will have an inclusion ratio of 1 for GST purposes. A GST tax will be assessed on any distribution made from the trust to a grandchild, regardless of the fact that the trust was GST exempt when funded.

While some commentators have concluded that this provision requires a trust to terminate on the date on which it no longer meets the definition of a qualifying trust, this does not appear to be the case. Rather, the trust, created before the enact date of the Bill, would automatically have an inclusion ratio of 1, meaning that distributions from the trust would be subject to a GST tax to the extent distributed to a skip person (that is, a grandchild, more remote descendant or someone assigned to such a generation) as of the date of distribution. Despite this nuance in interpretation, all commentators appear to agree that this rule serves its intended purpose of decimating multi-generational planning, regardless of when the trusts were created.

Considerations for Post-Enactment Multi-Generational Planning

Given the harsh implications of the potential new GST taxing regime, taxpayers may wish to plan differently for how formerly GST exempt dynastic trusts can be treated. For example, if the inclusion ratio becomes 1 in year 50 a distribution to a skip person will trigger a GST tax at the new increase transfer tax rates.

A trustee may opt to distribute assets in year 49 before the inclusion ratio for GST purposes changes. Also, a gift tax may be triggered on grantor trusts created after the date of enactment under what would be new Section 2901. On the other hand, if the gift had been made to a non-grantor trust, it would appear that no gift tax will be incurred. Thus, perhaps assets in a grantor trust created before enactment or a nongrantor trust can be distributed to the beneficiaries in year 49 thereby avoiding both the gift tax and the GST tax. A practitioner would need to exercise caution in facilitating these distributions in order to avoid attachment by a beneficiary's creditors and predators. All of this might result in very different planning.

Several different planning ideas might be addressed in planning such a distribution before the change in the GST inclusion ratio.

- Trust assets might be first contributed to an FLP or LLC so that on distribution there is some measure of asset protection, control over distributions since the trust will no longer hold assets, etc. Then the entity interests, perhaps non-controlling entity interests, can be distributed. This will not be the traditional application of discount planning (which will be prohibited for non-business assets in any event by the Act) but rather to substitute for the trust structure.
- Another consideration might be to retain in the trust sufficient cash and marketable securities that reasonably can be used to pay for educational and medical expenses of skip person descendants, and for lifestyle expenses of non-skip persons (since those distributions will not trigger GST tax even after the 50-year time period).

- When the distribution is made perhaps a concept similar to "generation jumping" that has previously been proposed in other contexts might be used. Instead of distributing to grandchildren, make the distributions to the youngest generation then living. That may avoid layers of future GST tax. This concept of generation jumping may be more important than ever in light of the restrictions on trust and GST planning contained in the Act. The concept is discussed in "Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation," The Chase Review (Spring 1996).

- It should be noted that for trusts created before enactment of the Bill, they need not provided for them to terminate at all time. It is just that their inclusion ratio will be 1 after the 50 year period. And although a (new) "qualifying trust", to have an inclusion ratio of more than 1 must terminate within 50 years of its creation, there does not seem to be a prohibition that it then be transferred to another trust, so asset protection for its assets might continue although generation-skipping transfer tax exemption could be gone.

Post Enactment Grantor Trust: Taxpayer creates a grantor trust after the date of enactment. A distribution from the trust will trigger a gift tax under Section 2901. Therefore, the only planning option would be to compare the potential gift tax exposure to the GST tax that would be assessed on distributions to skip persons. Recall that the gift exemption is not indexed for inflation.[28]

Modification to the Annual Exclusion and Apparent Elimination of Crummey Powers and 2503(c) Trusts

Despite some initial commentary suggesting that the Act reduces the annual exclusion down to $10,000, this does not appear to be the case. In the calendar year beginning after enactment, taxpayers will still be able to make gifts of $15,000, to continue to be indexed for inflation to any donee.[29]

However, the Act does remove the present interest requirement for annual exclusion gifts but then caps any gifts to a trust by two times the annual exclusion. Thus, the good news is that practitioners no longer have to chase clients for Crummey notices for gift tax return purposes (but estate panning counsel may still do so for trust compliance). Practitioners will be free of the endless debates as to whether the notices need to be in writing for not. The bad news is that annual gifts to trusts are limited to $30,000 in the aggregate no matter how many distant cousins have been granted a withdrawal power. This raises the question as to what happens with trusts that mandate that the trustee notify beneficiaries of their right to withdraw. Unless that right can be eliminated by a decanting it may be that the trustee will have to continue to comply with the terms of the governing instrument and give notices even if the intended tax effect of those notices is irrelevant.

Clients with life insurance or other plans funded with annual gifts should endeavor to shift value to those trusts before enactment of this restrictions.

Current Planning Option 1: Client has a typical ILIT with Crummey powers. Premiums are $75,000/year and are easily covered by the annual demand powers available to children and grandchildren who are beneficiaries of the trust. If a new law similar to the Act is enacted and transfers to trusts are capped at $30,000 per donor, indexed for inflation, the client will not be able to fund premiums without incurring a costly current gift tax cost. The client might be able to transfer marketable securities to the trust now,

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[28] See, generally, the JCT scoring of the Act, *supra* note 11.
[29] The Act, supra note 2 at Sec. 10. This section specifically modifies paragraph (1) of section 2503(b), leaving paragraph (2) of section 2503(b) unscathed. Sec 2503(b)(2) provides for inflation adjustments in $1,000 increments. See also JCT *supra* note 11.

using her exemption, so that the future premiums can be paid from a combination of the income and principal of the gift made. Alternatively, perhaps the client might prepay future premiums currently in order to minimize the future income tax costs.

Current Planning Option 2: Since GRATs are also on the chopping block, a wealthier client who does not have adequate exemption remaining to complete a large gift in 2021 before the new Act becomes effective as in the prior example, might create and fund a GRAT that terminates in favor of the ILIT. This had been a common approach when exemptions were lower for a non-GST exempt ILIT. The GRAT could be established to shift value to the ILIT, hopefully avoiding the need for additional gifting to the trust. This type of GRAT/ILIT plan might also be structured different than such plans had been historically. The traditional GRAT/ILIT plan would have entailed creating a two-year GRAT with the ILIT as the beneficiary. Each time an annuity payment was made, the client would re-GRAT the annuity into a new GRAT also benefiting the ILIT. Since GRATs are slated for restriction in the Act, then perhaps a tier of GRATs with different terms might be created now, before the new GRAT restrictions are enacted, so that the existing GRATs may be grandfathered and continue to fund insurance premiums for years to come, despite the restriction on annual gifts to trusts.

Interestingly, the Act strikes Sec. 2503(c) from the Code, eliminating the option enjoyed by modest taxpayers to set up trusts for the benefit of younger individuals, usually grandchildren. Section 2503(c) trusts are not generally a tool of the ultra-wealthy but more of an alternative for grandparents to make a gift up to the annual exclusion amount for a minor which would have to be withdrawn before the child turns age 21. It is hard to understand the abuse sought to be remedied by this decision. Practitioners will need to scour old trusts and determine whether any clients need to be advised if this provision is ultimately stricken from the Code. Perhaps, individuals will make greater use of Uniform Transfers (Gift) to Minor Act transfer in lieu of Section 2503(c) trusts,

Importantly, it appears that the Act does not affect contributions to a qualified tuition program which meets the statutory requirements of IRC Sec. 529 (“529 Plans”).[30] Nothing in the Act appears to liken 529 Plans to trusts to which excluded gifts are capped at twice the annual exclusion. Further, the Act does not appear to disrupt the ability of taxpayers to bunch contributions to a 529 Plan and treat them as ratable annual exclusion gifts over five years.[31] Thus, taxpayers looking to reduce wealth without making outright gifts may wish to fund 529 plans. However, it is important to be careful not to overfund a 529 plan as in the next example:

Example: Assume that a parent established a 529 account for the benefit of her son, Jerry. Jerry is newly married and has a daughter. The family would like for the 529 account to benefit Jerry’s newborn daughter. The account has approximately $100k in it.

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[30] IRC Sec. 529(b)(1) the term “qualified tuition program means a program established and maintained by a State or agency or instrumentality thereof or by 1 or more eligible educational institutions— (A) under which a person— (i) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (ii) in the case of a program established and maintained by a State or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account, and (B) which meets the other requirements of this subsection.”

[31] IRC Sec. 529(c)(2)(B).

Although plans must allow transfers from one family member to another, Prop. Reg. Sect. 1.529-5(b)(3)(ii) indicates that when there is a change of beneficiary on a 529 account from the child to the grandchild, the transfer will be treated as a taxable gift from the child to the grandchild.

Thus, the change of beneficiary will be deemed a gift from Jerry, which he can split with his wife and treat ratably over 5 years. In other words, each of Jerry and his wife can make an election so that each is only deemed to have made a gift of $10,000 to their daughter each year for 2021, 2022, 2023, 2024, and 2025. This is well under the expected annual exclusion in each of those years.

To the extent that this progressive wave in Congress continues, educational costs might be significantly reduced over the next few years. Taxpayers should carefully tailor contributions to 529 Plans in order to avoid overfunding them and creating another tax problem for their beneficiaries.

Impact of Multiple Proposed Changes on Estate Planning

With the restrictions on discounts, GRATs and other techniques, it will not only be difficult to leverage asset transfers to lessen the effects of gift and estate taxes, but also shift assets for asset protection purposes. Thus, for asset protection planning, planners will need to shift focus away from completed gift asset protection trusts ("DAPTs") to the use of FLPs, LLC and, possibly incomplete gift trusts. The ability to shift the value of FLP/LLC interests to trusts to fractionalize ownership will be more challenging.

The result might be a greater use of multi-member entities with other parties contributing assets to the partnership on formation so that the client seeking asset protection will have his or her interests and control diluted from inception. This will require a different approach to planning. The risks of triggering the investment company rules and unintentional gain if diversification results from the funding of a securities partnership may be more common an issue to review.[32] The use of assets protected under state law will grow in importance.

From a transfer tax planning perspective, it will be even more important to shift business opportunity outside the client's estate as that remains a transfer that may be difficult for the IRS to tax. Thus, a client with a new business endeavor, or, possibly, an expansion of an existing business, might endeavor to use that expansion or new endeavor as an opportunity to create a new entity owned by a trust already outside the estate. The analysis of the use of guarantees rather than seed gifts will have to be reconsidered. Under current law, a client seeking to transfer by sale $90 million asset might make a seed gift to the purchasing trust of $10 million and thereafter sell the target asset for its $90 million value. Under various interpretations of the mythical seed gift requirement (9:1 or 10:1), the above plan suffices. The Act's $1 million limitation on gifting may portend wider use of guarantees to support certain transfers.

Bringing It All Together: Some More Examples

[32] See IRC Sec. 721.

The Act is a comprehensive attempt to reshape the transfer tax that has been used by planners for the past several decades to help their clients achieve estate planning, business succession and asset protection goals. Some might say that the author of the Act used a sledgehammer instead of a scalpel in crafting some of the most onerous provisions. In order to understand how each provision of the Act might work together, please consider the examples set forth below.

Distributions from a Grantor Trust created or funded Post-Enactment: Following enactment of the Act, Jack makes a gift of $1 million to a grantor trust for the benefit of his sister, Jill and her descendants, using up his entire gift exemption. In year 49, Jack is still alive. The trust has enjoyed growth of approximately 4% but made no distributions so has an approximate value of $6,840,000. The Trustee is considering whether to distribute the balance in trust to Jill and her 11 descendants in order to avoid implication of the GST tax provisions under the Act.

The annual exclusion is indexed for inflation pursuant to IRC Sec 2503(b)(2), which was not changed by the Act. For the purposes of this example, assume that the annual exclusion in year 49 is $20,000.

Further, the Act does not limit application of the annual exclusion to gifts of a present interest so it would seem that even though distributions are being made from a trust that was funded years earlier, the distribution should be eligible to be reduced by annual exclusions.

Jack's spouse has agreed to split the transfers.

Based on the foregoing, the total gift tax[why is gift tax due? --now I see; it is a grantor trust but you didn't say that] due would be $837,000, calculated as follows:

Approximate Value of the trust in Year 49:		6,840,000
Less exclusion for prior gifts to trust:		(1,000,000)
Less annual exclusions under 2503(b) split with spouse:	12	(480,000)
Total taxable gift:		**5,360,000**
Total tax:		**837,000**

Since the gift tax and the GST tax are separate, it would seem that this plan would necessarily need to be undertaken prior to year 50 for a grantor trust subject to the special rules under the new Sec 2901. Otherwise, any distribution from the trust would be subject both to a gift tax and have an inclusion ratio of 1, meaning that any such a distribution from the trust in year 50 or beyond to a skip person would likely be subject to both taxes.

It is not clear whether distributions made for health or education would be eligible for an exemption from either the gift tax or GST tax under this new taxing schema although there is no indication they would disappear.

Might it be advantageous for family members to serve in fiduciary positions and earn fees to lessen the assets in the trust subject to GST tax? That might provide some marginal benefit if the fees could be supported as reasonable under state law. However, those fees would trigger income tax at what may be new higher rates. Further, to the extent that the trust is a grantor-type trust, the grantor would not be able to deduct the fiduciary fees as a matter of current income tax law. It would not seem that paying out fiduciary fees would present any benefit to the family in this circumstance.

Distributions from a NonGrantor Trust: If the trust at issue in the earlier example had instead been a nongrantor trust created by Jack for Jill's benefit after the date of enactment, a distribution from the trust should not trigger a gift tax under what would be new Section 2901. Thus, a planning option might be to distribute assets out of the trust in year 49 to avoid implicating the GST tax on distributions from the trust in year 50 and beyond. While that may avoid the early imposition of a GST tax, it also exposes the formerly protected trust assets to the reach of an ex-spouse and creditors. . However, although a trust must terminate in 50 years to be a "qualifying trust" to have an effective Inclusion Ratio of less than 1, the Bill does not appear to prohibition the trust assets from being distributed to another trust which could provide asset protection and fundamental management that an outright distribution might not.

Assets in the trust could be held in family partnership or limited liability company structures so that when distributed, commingling can be limited or avoided to minimize divorce risk and also to provide creditor protection following distribution. Once the distribution is received, perhaps each beneficiary should make transfers to incomplete asset protection trusts in order to provide an additional measure of protection from divorce or creditor claims. If the beneficiary has unused exemption, they might be able to use that amount, but that too is limited to $1 million under the new law and is not indexed for inflation. However, using that exemption on receipt of the benefactor's trust distribution, while limited, may make some sense. Since grantor trusts will be subject to so many restrictions it may not be feasible to create a grantor trust in order to accomplish a tax-free sale of the FLP/LLC interests, since those assets will be subjected to estate inclusion, etc.

Distributions from a Pre-Enactment Trust: Taxpayer creates a trust prior to the date of enactment. The GST tax will apply 50 years hence. In year 49 the assets can all be distributed to avoid the GST tax. No gift tax will be incurred under proposed new Section 2901 as the trust is grandfathered from that provision so long as no contributions were made after enactment of the Act. The assets, as discussed in the preceding example, can be restructured into FLP/LLC solution to provide divorce and asset protection although paying the assets to another trust (even DAPTs the beneficiaries create likely would be preferable. The beneficiary could evaluate the same options suggested above.

Conclusion

The Act is an aggressive opening argument in what will likely be the soundtrack of the next few months for tax practitioners. Even Senator Sanders recognizes that it faces an uphill battle in a divided Senate. Still, it appears to have the support of an ever-growing number of progressive politicians and their constituents for whom the concerns wealth inequality has resonated, particularly over the course of the pandemic. But it is impossible to predict what may be enacted or when it will be effective. Therefore, practitioners should guide clients to reasonably and flexibly implement planning strategies as quickly as feasible in order to endeavor to complete planning before the possible date of enactment.

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