Scary Tax Law Changes – and Not Just for the Super Rich

By Robert D. Kaplow, Esq.

It looks like Congress may be getting into the Halloween scary season a little bit early. On Monday, September 13, 2021, the House Ways and Means Committee released some tax law proposals to incorporate into a budget reconciliation bill. This proposal contains many provisions that ought to scare most taxpayers, explained below.

1. Income Tax Changes.

The top marginal individual income tax rate would increase from 37 percent to 39.6 percent. It would apply to married individuals filing a joint return with taxable income over $450,000 and estates and trusts with taxable income of over $12,500. The proposal would also impose a surcharge equal to 3 percent of a taxpayer's modified adjusted gross income over $5 million.

In addition, the proposal would increase the highest capital gains tax rate from 20 percent to 25 percent, effective for tax years ending **after September 13, 2021**, with some exceptions for gains and losses incurred before that date or for gains recognized after that date (if entered into according to a binding contract before September 13, 2021.) As under current law, the capital gains would still be subject to the additional net investment income tax of 3.8 percent.

2. Estate and Gift Tax Provisions.

a. Estate and gift tax exemption.

The estate and gift tax exemption of $11.7 million, currently scheduled to be reduced in 2026, will be reduced as of January 1, 2022, to $5 million, as adjusted for inflation from 2011. (Most commentators expect this amount to be approximately $6 million.) This would continue to be an exemption per deceased individual or donor; therefore, a married couple would still be able to leave approximately $12 million to their family without any estate tax. The existing rules pertaining to portability, where a surviving spouse can use the unused portion of the deceased spouse's exemption, would continue. Thus, as we have stated in previous articles, **high net worth clients are urged to consider making a substantial gift in 2021 to take advantage of the high exemption before it is reduced.**

b. Grantor Trusts.

While the above reduction in the estate and gift tax exemption may only affect a small number of taxpayers, a proposed rule would have a drastic effect on many other clients. For several years, we and other tax advisors have recommended the creation of so-called "intentionally defective grantor trusts." These trusts effectively remove assets from a person's estate for estate tax purposes while requiring the trust's grantor to pay the income tax attributable to income in the trust. Although this may seem unfair, it provides a way to make additional gifts to the trust indirectly without any gift tax since the trust does not have to reduce its assets by paying the income taxes. The proposal would do away with creating new grantor trusts and adversely affect contributions to an existing grantor trust. The effect of the changes would be that any new grantor trust's assets would be included in the grantor's estate upon the grantor's death.

This change would drastically affect the use of **irrevocable life insurance trusts ("ILIT")**. We have many clients of moderate wealth who created these trusts to own a life insurance policy to provide liquidity while removing the proceeds from their estate and also protecting the trust assets from claims of beneficiaries' creditors. The new proposal would result in adverse tax consequences for gifts to ILITs to pay premiums even if the ILIT was created before the new law's effective date. For example, assume a client formed an ILIT to own a $2 million life insurance policy, and the client is gifting $15,000 a year to the ILIT to pay premiums. Under existing law, the life insurance proceeds will not be included in their estate when the insured dies. However, going forward, the $15,000 annual contribution would be deemed a tainted gift to a grantor trust, so a portion of the life insurance proceeds would be included in the individual's estate. Therefore, if the cumulative annual contributions to a pre-existing ILIT after the new law's effective date equal 50 percent of the total premiums paid for the policy, then 50 percent of the policy proceeds would be included in the estate of the grantor.

What can be done in this situation? If including life insurance proceeds in your estate would generate an estate tax, we would recommend making a large contribution to the ILIT in 2021 to **prefund the life insurance premiums.** If this is not possible, we would recommend **loaning funds** to the trust, although that loan would have to be repaid upon the insured’s death. Another alternative would be to convert the policy to a **paid-up policy** with a lower death benefit, but no further premiums would have to be paid.

c. Family Limited Partnerships.

Another technique we have recommended is to contribute assets to a family limited partnership or a family limited liability company and then take a valuation discount in connection with gifts of the partnership or membership interest for the lack of marketability and minority interest represented by the partnership interest. The proposal would prohibit discounts in connection with valuing gifts of interests in family partnerships or limited liability companies which own non-business assets, which are passive assets held for the production or collection of income and not used in the active conduct of a trade or business. Therefore, this proposal would remove a valuable valuation technique that we have used in connection with gifting.

3. Effective Dates.

The effective date of these provisions is uncertain, and it is also unclear whether or not any of these provisions will be enacted into law. In case these proposals are enacted, protect yourself by contacting your estate planning attorney at Maddin Hauser to discuss possible steps to take to reduce your estate or income tax exposure going forward.