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What You Need To Know About the “For the 99.5 Percent Act”

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On March 25, 2021 a bill entitled the “For the 99.5 Percent Act” was introduced to Congress by Senator Bernie Sanders of Vermont. “The Act,” as we will refer to it here, proposes dramatic changes to the estate and gift tax system in the U.S., and would abolish or severely limit a number of estate planning strategies that wealthy families have relied upon for many decades.

Why are we paying attention to something that is only a legislative proposal at this point, and may wind up being modified in any number of respects, even if it is ultimately enacted? One reason is that the Act is the distillation of policy ideas that go back at least to the Obama Administration; many features of the Act have been championed by certain legislators for a long time. More importantly, if the Act were to be included in larger infrastructure legislation under the Budget Reconciliation process, it could become law by passing the House and receiving fifty Democratic votes in the Senate (plus the vote of Vice President Harris). The mere possibility that the Act could become law this year has everyone in the planning community paying close attention.

So what does the Act do?

Rates and Exemptions

The last two decades have seen a lowering of estate and gift tax rates and increases in the amounts that are permitted to pass free of estate and gift taxes. Under current law, the maximum rate of Federal estate tax and gift tax is 40%, and the exemption against these taxes is now $11.7 million. So, a married couple with two exemptions intact need only worry about Federal estate tax if their combined wealth exceeds $23.4 million.

The Act would change all this with estates over specific levels being subject to progressively higher levels of tax:

Estate Size	Marginal Estate Tax Rate
$3.5 million to less than $10 million	45% (12.5% increase from current rate)
$10 million to less than $50 million	50% (25% increase from current rate)
$50 million to less than $1 billion	55% (37.5% increase from current rate)
$1 billion or more	65% (62.5% increase from current rate)

Moreover, the estate tax exemption --- currently $11.7 million --- would be reduced by 70% to **$3.5 million**. The gift tax exemption --- also currently at $11.7 million --- would be reduced by 91% to **$1 million**.

The estate of that same married couple with a net worth of $20 million who face **no** estate tax liability under current law would, under the Act, incur a **$6.35 million** estate tax liability.

Grantor Trusts

Along with increasing estate and gift tax rates and reducing exemptions, the Act also takes away many of the planning tools that have traditionally been used by wealthy families to shelter wealth from estate tax. For decades, the most important of these tools has been the irrevocable "grantor trust." Using the elevated gift tax exemptions of recent years, individuals and families have moved vast amounts of wealth into trusts that are "outside" the grantor's taxable estate at death but are still considered to be "owned" by the grantor of the trust for income tax purposes. This strategy enables a patriarch or matriarch to move wealth for estate planning purposes but continue to pay the trust's income taxes during lifetimes, thus shifting more wealth to the next generation.

The Act would change this.

Under the Act, any grantor trust would be included in the estate of the deceased grantor (making them subject to estate tax) and would treat distributions from the grantor trust to beneficiaries as gifts (making them subject to gift tax). These provisions would apply to any grantor trust created, or receiving a contribution, *on or after the date of the enactment of the Act*. Thus, grantor trusts created and funded prior to the date of enactment will continue to enjoy the benefits of the current law, but grantor trusts created or funded after that date will not.

It would be difficult to overstate the importance of this change in the law. Planners would have to choose between creating trusts that pay their own income taxes (so called non-grantor trusts) or making gifts to non-trust structures like LLCs or partnerships. Also, as this provision currently stands, it would blow up the estate plans of many less-than-super-rich Americans. For example, a young executive purchases a term life insurance policy that he owns through a life insurance trust. He was told that the policy would be sheltered from estate tax at his death. Not any more. Even if the trust was created and the policy purchased before the effective date of the Act, if the client continues to make contributions to the trust to pay premiums, the portion of the trust attributable to the later contributions will be subject to estate tax. A pretty unpleasant surprise.

Generation-Skipping Trusts

Under current law, every individual can transfer up to $11.7 million during lifetime or at death to a long-term trust that benefits successive generations of a family. If these so-called "generation-skipping" or "dynasty" trusts are created under the laws of a state that permits a trust to continue in perpetuity, the trust can go from generation to generation without ever being subject to estate or gift taxes. Thus under current law the great-great-great grandchild of a person who created a dynasty trust in 2021 can receive unlimited distributions in the future without those distributions being subject to estate tax, gift tax or generation-skipping transfer (GST) tax.

The Act caps the duration of trusts that would otherwise be GST exempt at **fifty years**. This rule would apply both to newly-created trusts, and pre-existing trusts. After the fifty-year grace period expires, distributions from the trust to a "skip person," i.e. someone more than one generation removed from the grantor of the trust, would presumably be subject to the dreaded GST tax --- a tax which very few families in recent decades have had to pay (the rates being the same as the estate tax discussed above).

Grantor Retained Annuity Trusts (GRATs) and Beneficiary Defective Inheritors Trusts (BDITs)

GRATs are an estate planning technique that is sometimes used to transfer future appreciation in the value of an asset with little or no gift tax cost. These are used most often by clients who own assets (e.g. pre-IPO stock) that are expected to appreciate dramatically in value over a relatively short period of time.

Under the Act, future GRATs will be required to have a minimum term of ten years, and the gift made on inception will be required to be at least 25% of the value of the trust or $500,000 (whichever is greater). It is hard to imagine anyone continuing to use GRATs as an estate planning technique with these constraints.

BDITs, sometimes referred to as 678 Trusts, represent another GRAT-like estate planning technique that the Act also targets. Whether newly-created or existing, BDITs would be pulled back into the estate of the "deemed owner" at death.

Valuation Discounts

Valuation discounts have been an important feature of estate and gift tax planning for decades. Current law allows the value of assets to be discounted for estate and gift tax purposes due to factors like lack of marketability (i.e. illiquidity) and minority interests. Proper structuring could enhance discounts --- indeed, create discounts --- even if the underlying assets consisted of marketable securities or other highly liquid assets.

Much of the actual text of the Act is devoted to limiting valuation discounts. Under general rules assets must be used in the active conduct of a trade or business to qualify for a valuation discount, and transfers of interests in entities that hold "non-business assets" receive no discount. So, for example, a transfer of an interest in real estate in which the transferor does not materially participate in management would be deemed a transfer of a "non-business asset", with no discount being allowed.

Discounts for transfers of minority interests are also limited by the Act. If the person making a transfer, and the person receiving the transfer, together with other family members, have either (i) control or (ii) majority ownership of what is being transferred, no minority discount is allowed. This family aggregation of control and ownership is a major departure from prior law.

These new valuation rules are effective for transfers made after the date of enactment of the Act.

Annual Exclusion Gifts

The Act would also impose severe restrictions on Annual Exclusion Gifts. Currently, anyone can make as many gifts of $15,000 per year as he or she chooses, with no limit on the number of gifts a single donor can make, or the number of gifts a single recipient can receive from different donors. Under the Act, the Annual Exclusion is reduced to just **$10,000** per annum, and a donor is limited to giving away just **$20,000** in total each year. No recipient can receive more than **$10,000** in total in a year.

If enacted (the provision would apply to tax years after the year of enactment), this radical restriction on annual giving would certainly have many unintended consequences. Life insurance trusts, for example, are often funded with annual exclusion gifts to avoid using up the donor's lifetime gift tax credit. It may be difficult to maintain policies that require annual premiums in excess of $20,000 per year under this proposal.

Where Do We Go From Here?

We have noted above that some provisions, such as those on tax rates, exemptions and annual exclusions, would only apply in 2022 and thereafter. Other provisions, such as those on grantor trusts and valuation discounts, would apply as soon as the Act is enacted in Congress.

When might this bill be enacted? Most commentators are projecting that the earliest date that the Act could become law would be in October of this year as part of the Budget Reconciliation process. Reconciliation permits legislation to be enacted in the Senate without a 60-vote majority --- the fifty Democratic senators and the added vote of the Vice President would be sufficient to achieve passage. So in theory the Democratic majority in the House of Representatives and the fifty Democrats in the Senate could pass the Act --- if they remain united.

However, one wonders whether some of the more aggressive provisions of the Act, such as the 65% estate tax rate for billionaires, the 50-year limit on GST trusts, and restricting donors to two $10,000 annual exclusion gifts, might be points of negotiation to capture the support of certain legislators. Time will tell.

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Planning Point

Whether the "For the 99.5 Percent Act" ultimately goes nowhere or is enacted into law in its current form, there should be one very important take-away for wealthy individuals and families. The current gift tax exemption --- $11.7 million --- will be in effect until the Act is enacted. Under the provisions of the Act, a gift to an irrevocable grantor trust made before enactment of the Act is effectively "grandfathered" and is not included in the estate of the grantor. Clients who have the means to do so should be considering getting their trusts created and funded as soon as possible. If the Act becomes law, they will have a grandfathered trust; if it does not, they will have done great estate planning.

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Paul is the Chief Planning Officer and a Partner in the New York office. He has over twenty-five years of experience in helping families create and optimize their wealth planning structures. His expertise extends beyond traditional trust and estate planning to areas such as asset protection planning, income tax strategies, charitable and philanthropic structuring, and planning for international families and individuals.

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