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BIDEN GREEN BOOK PROPOSALS

Significant Changes to the Estate Tax Planning Regime

May 12, 2022

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Last year, the Biden Administration and Congress issued a variety of proposals that would have eliminated the use of several popular estate tax planning strategies. Those proposals did not go very far. Despite that setback, on March 28, 2022, the Biden Administration released its annual Green Book proposals. The Green Book contains the Administration's policy tax and budget policy goals for the coming year. This year's Green Book proposes significant changes to the current estate tax planning regime.

Given last year's failure and President Biden's current low poll numbers, is there anything to be concerned about? The only thing for certain is that things can change quickly in Washington. To boost its chances of success, the Biden Administration modified their previous stance to address some of the lobbyist arguments that helped kill last year's proposals. Here is a summary of some noteworthy provisions in this year's Green Book. The intent of these provisions is to increase taxes on wealthier taxpayers and negate the effectiveness of several popular and commonly used estate planning strategies.

1 BILLIONAIRE'S TAX

Contrary to its title, this tax is not limited to billionaires. Although it has the same title as last year's proposal by Senator Warren, it is different. Rather than being a percentage tax on net assets, this year's Green Book proposal is a tax on income, gains, and unrealized gains for persons meeting a minimum threshold amount of wealth. Persons with more than $100 million in net worth would be subject to a 20% minimum tax on all income, including unrealized gain. Additionally, the Green Book proposal would tax capital gains for high-income earners (over $1 million) at ordinary income tax rates. This provision would increase taxes on wealthy individuals and require asset appreciation to be taxed, even if the assets are not sold.

2 ELIMINATION OF "TAX BURN" FROM GRANTOR TRUST

The tax on income produced by a grantor trust is paid by the trust creator, not the trust. The trust income tax paid by the trust creator is not, however, considered a gift. As a result, the trust creator's estate is reduced every time it makes tax payments on trust income. At the same time, the grantor trust's assets can grow estate tax free, unimpeded by income tax payments. This is commonly referred to as "tax burn." This year's Green Book proposal differs from last year's grantor trust proposal because instead of simply ending grantor trust treatment for income tax purposes, it requires the trust creator to treat any income tax payments made on behalf of a grantor trust as a taxable gift. This year's Green Book proposal would adversely impact most grantor trusts but should not affect life insurance trusts, even though they are generally set up as grantor trusts. By treating trust income taxes paid by the grantor as a gift, this provision would eliminate an important benefit of using a grantor trust.

3 ELIMINATION OF NON-TAX TREATMENT OF SALES TO GRANTOR TRUSTS

A common estate planning strategy involves a grantor selling assets to a grantor trust, often in exchange for a promissory note (commonly known as an installment sale to an intentionally defective grantor trust). Currently, any sale transaction between a grantor and a grantor trust does not result in taxable gain for income tax purposes. This year's Green Book proposal eliminates the ability of a grantor to sell assets to an irrevocable grantor trust without triggering taxable gain. A requirement that taxes be recognized on sales by the grantor to the grantor trust would increase the costs of using grantor trusts and make the use of grantor trusts in estate planning a much less attractive option.

4 RESTRICTIONS ON THE TERM OF GRANTOR RETAINED ANNUITY TRUSTS

GRATs are a popular estate planning technique whose success depends on the trust assets appreciating at a higher rate than the IRS mandated interest rate (which is a low rate compared to bank or other traditional lending rates). The growth of assets in excess of the IRS mandated interest rate is removed from the grantor's estate without incurring gift tax. Studies have shown that short-term GRATs (2 or 3 years) are usually the most effective at getting assets out of an estate because assets held by GRATs generally have explosive growth in short periods of time, but then growth tapers. By requiring assets to be held for longer periods of time, it reduces the average annual growth rate which, in turn, means the amount of growth in excess of the IRS mandated, is lower. The result is less assets are transferred out of the grantor's estate. Also, if a grantor dies during the annuity payback period to the grantor, the GRAT assets can be pulled back into their estate. By lengthening the GRAT term, it is more likely that a grantor will not survive the GRAT annuity payback term and assets will be pulled back into the grantor's estate. This year's Green Book proposal requires GRATs last for a minimum term of 10 years. The intended result is to limit the effectiveness of GRATs.

5 ELIMINATION OF ZEROED-OUT GRATS

GRATs are generally structured to "zero-out" the gift tax consequences of assets transferred to the GRAT. This means that assets can be transferred to the GRAT without using up any gift tax. If the GRAT doesn't work, the grantor has not lost anything other than the transaction costs of setting up the GRAT. This means the grantor can keep creating new GRATs until, hopefully, the strategy is successful. This year's Green Book proposal would require a minimum gift be recognized on asset transfers to GRATs of 25% of the value of the gift or $500,000. This would result in a gift tax consequence for every GRAT created, even if the GRAT is unsuccessful.

6 TAX IMPOSED ON ASSET SWAPS

A commonly used provision to qualify an irrevocable trust as a grantor trust for income tax purposes is the power of the grantor to substitute trust assets with other non-trust assets, provided the assets are of equal value. One technique is to utilize the swap provision when GRAT assets experience significant growth, resulting in significant imbedded gains. An older grantor can substitute non-trust assets of equal value, but with little or no imbedded gain, in exchange for the GRAT assets which have significant unrealized capital gain. This allows the GRAT to avoid holding assets with significant imbedded capital gains. In return, the grantor owns assets with significant unrealized capital gains and the grantor's heirs obtain a "stepped-up" basis at death for those assets for income tax purposes. Under the Green Book proposal, tax-free GRAT asset swaps would be prohibited.

7 LIMITS ON DYNASTY TRUSTS

Currently, many states allow trusts to remain in existence for hundreds or sometimes thousands of years. If properly created, these trusts will grow free from gift, estate, and generation skipping transfer tax ("GST") for their entire existence. This year's Green Book proposal limits the duration of a trust's GST exempt status no further than the lifetime of great-grandchildren alive when the trust is created, or for existing trusts, alive at the date of enactment.

8 CAPITAL GAIN REALIZATION

Upon death or at the time appreciated property is gifted, this year's Green Book proposal would require capital gains to be recognized. Every individual taxpayer would receive a $5 million lifetime exclusion. Spouses will be able to transfer (port) this $5 million figure to the survivor of them.

9 LIMITATION ON GAIN DEFERRAL FOR 1031 EXCHANGES

Section 1031 exchanges are not an estate planning strategy, but they are utilized by many high net-worth taxpayers. Currently, Section 1031 allows investment property to be sold without capital gain recognition, provided a replacement property is purchased with the proceeds. There is no limit on the amount that can be deferred under a Section 1031 exchange. This year's Green Book proposal limits the amount of gain that may be deferred under Section 1031 to $500,000 ($1 million in the case of married individuals filing a joint return) per taxpayer, per year.

10 INCOME TAX RATES FOR HIGH EARNERS

Also worth mentioning is the Green Book proposal to increase the top marginal tax rate from 37% to 39.6% for married individuals filing a joint return with taxable income over $450,000 ($400,000 for unmarried individuals).

This year's Green Book proposals do not currently appear to have sufficient support. However, discussions in Washington D.C. are ongoing. Given that dynamic, it is worth keeping an eye on this year's Green Book proposals in case they suddenly find support. Regardless, due to sunsetting, even if no Congressional action occurs, the estate tax regime will change at the end of 2025. Estate tax exemption amounts will decrease to $5 million, as adjusted by inflation. Outright gifts will not be subject to "claw- back" of assets gifted prior to the sunset of the current estate tax exemption amount at the end of 2025. That means if a client gifts $12,060,000 now but the estate tax exemption amount is reduced to $5,000,000 in 2026, the entire $12,060,000 will still be free of any estate tax. That is a valuable planning opportunity that should be utilized by wealthy clients. Having said that, the IRS recently issued proposed regulations providing that "claw-back" will apply to certain types of gifts made prior to the sunset of the current estate tax exemption amount at the end of 2025. Although valuable estate planning opportunities exist, they should only be done after consultation with a qualified estate planning professional.

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