The Implications for Estate Planning of Proposed Tax Provisions of the Build Back Better Act

Client Alert

10.12.21

What You Need to Know

- The House Ways and Means Committee has approved the tax provisions of President Biden's Build Back Better Act, a significant first step towards passage.
- If passed as drafted, the proposed legislation may restrict the ability of higher net worth individuals to pursue certain estate planning strategies.
- Taking action now on the gifting of assets could avoid the potential negative impacts of less favorable tax laws in the future.

On September 15, 2021, the House Ways and Means Committee approved the legislative tax provisions of the Build Back Better Act (BBBA). The legislation is designed to implement the tax law changes proposed by President Joe Biden earlier this year. While the approval of the House Ways and Means Committee is a significant step forward, the bill must still meet with additional committee approval before it can move to the U.S. House of Representatives at large, and then to the U.S. Senate, before potentially being signed into law.

While the ultimate provisions of any new law are uncertain, it appears as if more restrictive rules may be implemented. Therefore, now is an opportune time for higher net worth individuals to consider taking affirmative steps to take advantage of the current, more favorable, tax laws.

While the BBBA contains numerous tax-related provisions, this Client Alert focuses on the estate planning implications of the proposed legislation.

Lower Gift and Estate Tax Exemptions

The BBBA proposes to reduce the federal estate and gift tax exemption from the current $11.7 million per individual to $5 million per individual (indexed for inflation). As currently proposed, this provision would be effective as of January 1, 2022, and is not expected to be applied retroactively to gifts made in 2021. In addition, the Internal Revenue Service previously confirmed that there will be no "clawback" if a person utilizes the exemption when it is high but dies after the exemption has been reduced.

As the reduced exemption amount is not expected to apply to gifts made in 2021, there is a window for possible estate tax planning through the end of this year. By way of illustration, assume a taxpayer, in 2021, gifts $11.7 million to an estate tax exempt trust for the benefit of his spouse and children. No gift tax would be paid, and the trust assets (plus any earnings and appreciation) would be removed from the taxpayer's (and spouse's) estate. In contrast, if no gift is made and the exemption should drop to $5 million in 2022, the opportunity to shield the additional $6.7 million, plus its growth, will be lost. When determining whether to gift assets, the impact of carryover versus step up in basis should also be considered, as that could impact the amount of gain that is recognized when heirs ultimately sell the asset.

Change in Grantor Trust Treatment

In connection with gifting, some of the more complicated mechanisms by which gifts can be made stand to be impacted by the BBBA. Under current law, a certain type of trust (known as a "grantor trust") allows for the individual funding the trust (the "grantor") to enjoy income tax benefits with respect to transactions between the grantor and the trust without causing the trust assets to be includible in the grantor's estate.

For example, a grantor may make a sale to his or her own grantor trust without creating an income tax event. Grantor trusts also allow the grantor to personally pay all of the income tax on the income that the trust realizes, thereby allowing more assets to remain and grow in the trust. Also, a grantor can retain the power to remove assets from a grantor trust and replace them with assets of equivalent value, which can be of great assistance in connection with avoiding or reducing certain types of gains.

Under the BBBA, grantor trusts may no longer be excluded from the taxable estate of the grantor and sales between an individual and their own grantor trust would be taxable for income tax purposes. These provisions are proposed to be effective only with respect to trusts created after the enactment of the BBBA (or contributions made after the date of enactment to pre-enactment trusts). Consequently, a taxpayer who wants to explore these options should plan to have his or her trust fully created and funded by the end of 2021.

Elimination of Certain Valuation Discounts

Another current gifting technique is to take a valuation discount on gifted assets that comprise shares or interests in a business entity. The BBBA, however, proposes to eliminate these discounts for gifts of entities (or interests in entities) that hold non-business assets. For tax purposes, non-business assets are defined as passive assets that are held for the production of income and not used in the active conduct of a trade or business. Certain exceptions are provided for assets used as working capital of a business.

For transfers of interests in a closely held entity, the BBBA eliminates valuation discounts for lack of control or lack of marketability that are attributable to the non-business assets held by the entity. This provision may have a significant impact on the transfer of interests in family partnerships and LLCs.

Again, this change is expected to be effective for transfers made after the effective date of the legislation, so it would be important to consider making discounted gifts of entities holding passive assets in the very near future.

The members of our **Tax, Trusts & Estates Department** are available to answer your questions and provide guidance concerning your current estate and tax planning strategies.

Related Attorneys

Michael K. Feinberg

Partner
732.476.2710
Email

Michael A. Backer

Partner
732.476.2450
Email

Thomas C. Senter

Partner
732.476.2650
Email

Brian Selvin

Partner
732.476.2434
Email

Lauren M. Ahern

Counsel
732.476.2398
Email

Meghan E. Anderson

Associate
732.476.2720
Email