PALLAS
CAPITAL ADVISORS

"Tempus Fugit"

(Yes, the Golden Age of Estate Planning is Quickly Flying By)

September 2021

Back in October of 2020, we wrote that the "Winds of Change are Blowin'". Earlier this year, we talked about a "Paradigm Shift" under President Biden's tax policy. Just a few months later, on September 13, 2021, the House Ways and Means Committee released the first draft of a tax proposal designed to raise roughly $2.9 trillion over the next 10 years.

The bill is noteworthy because, like a weathervane, it shows which direction the wind blows - many of the bill's provisions seem designed to specifically attack planning commonly done by high net worth (HNW) and Ultra-HNW taxpayers. There are some measures that didn't make this latest cut – such as equalizing the top income and capital gains rate, or the elimination of the step-up in basis. While some provisions in the proposal may also change as the bill works through Committee, and then through the Senate, most practitioners agree that the broad provisions which target HNW and UHNW individuals and families will appear in some fashion in the bill's final form, and eventually be signed into law by President Biden.

We've summarized the key financial provisions that will have an impact on taxpayers' retirement, income-tax, and estate tax planning.

INCOME AND CAPITAL GAINS TAXES

Top individual tax rate increases to 39.6%: Currently, married filing jointly taxpayers reach the top tax bracket (37%) at $628,301. Instead, the bill will impose a 39.6% income tax on the same taxpayers, starting at $450,000. For a taxpayer earning $628,301 - this amounts to an $8,201 increase in income tax alone (omitting other tax increases). Not only is the top rate increasing, but the new 39.6% bracket significantly lowers the amount of taxable income a taxpayer can have before finding themselves in the top tax bracket.

	Single		Married Filing Jointly	
	Current	Proposed	Current	Proposed
10%	$0 - $9,950	$0 - $9,950	$0 - $19,900	$0 - $19,900
12%	$9,951 - $40,525	$9,951 - $40,525	$19,901 - $81,050	$19,901 - $81,050
22%	$40,526 - $86,375	$40,526 - $86,375	$81,051 - $172,750	$81,051 - $172,750
24%	$86,376 - $164,925	$86,376 - $164,925	$172,751 - $329,850	$172,751 - $329,850
32%	$164,926 - $209,425	$164,926 - $209,425	$329,851 - $418,850	$329,851 - $418,850
35%	$209,426 - $523,600	$209,426 - $400,000	$418,851 - $628,300	$418,851 - $450,000
37%	$523,601+		$628,301+	
39.6%		$400,001+		$450,001+

Source: Kitces.com

3% income tax surcharge: Very high-income earners - over $5,000,000 - will also face a 3% "surcharge" amounting to a combined federal income tax bracket of 42.6%. Many high-earners have only one or two years in that income level - maybe from selling their business or other such events.

> **Planning Tip:**
> Consider structuring sales to happen over time in installments or other arrangements to protect the individual from hitting those levels of income.

Top capital gains rate increases to 25%: Paired with the new top ordinary income tax rate is a new top long-term capital gains rate of 25%.

Unlike the proposed change to ordinary income tax rates, which would not be effective until 2022, the proposed changes to the top long-term capital gains rate would go into effect immediately, impacting long-term capital gains incurred on or after September 14, 2021.

> **Important:**
> If the proposed bill becomes law, taxpayers will not be able to sell appreciated assets before the end of this year in order to avoid the higher capital gains tax rate. There is an exception for unmodified, binding contracts that were entered into on or before September 13, 2021, and that close before the end of 2021.

Note that the new 25% long-term capital gains rate also applies to dividends and investors with one-time windfalls, such as selling a home with a large taxable gain.

SMALL BUSINESS OWNERS MAY FACE ADDITIONAL TAXES

3.8% net investment income tax*:* If the proposal is enacted, once an S corporation owner's Modified Adjusted Gross Income (MAGI) exceeds the proposed "applicable threshold", S corporation profits will be added together with 'regular' investment income to produce something the bill calls "Specified Net Income." And ultimately, the greater of a client's net investment income or Specified Net Income will be subject to the 3.8% Net Investment Income Tax (NIIT). The proposed "applicable thresholds" are $400,000 for single filers and $500,000 for joint filers.

Limitation of 199A deduction: A proposed change to section 199A (20% pass-through business deduction) would set the maximum allowable deduction at $500,000 for a joint return, $400,000 for an individual, and $250,000 for a married individual filing separately. The proposed rule would apply to taxable years beginning after December 31, 2021.

Limitations on the qualified small business stock exclusion: Currently, under IRC § 1202, taxpayers may exclude a specific percentage (in some cases up to 100%) of capital gain from income when selling qualified small business stock ("QSBS"). The bill provides that taxpayers with AGI of $400,000 or more and all trusts and estates would only be allowed to exclude 50% of the eligible gain. This provision would generally be effective for sales occurring after September 13, 2021.

TRUSTS AND ESTATES

Exemption to be lowered: The proposal reduces the federal estate, gift, and generation-skipping transfer tax exemption to $5 million, adjusted for inflation, beginning for estates of decedents dying and gifts made after December 31, 2021. Therefore, those with estates larger than this exemption (or projected to be larger at death) should be looking to use as much of the exemption as possible before year-end by gifting assets out of the estate.

Grantor trusts: a "Seismic Shift" in estate planning for HNW clients. The bill as proposed would effectively close the benefit of intentionally defective grantor trusts for estate and gift tax purposes, as it would subject a grantor trust to estate taxes (when the trust's deemed owner dies) or gift taxes (when grantor trust status is terminated while the deemed owner is still living). Further, it would negate the gift and the estate tax benefit of any trust that has grantor status. For example, in spousal limited access trusts (SLATs) and grantor retained annuity trusts (GRATs), the appreciation of the assets in the trust would be subject to gift or estate tax upon the termination of grantor trust status, negating the benefit of having made an earlier taxable gift.

Distributions from grantor trusts to beneficiaries would be treated as a gift during the grantor's lifetime.

Irrevocable Life Insurance Trusts (ILITs): Proceeds of a life insurance policy that are owned inside an irrevocable life insurance trust, which is typically a grantor trust, could be subject to estate taxation if either the trust is established after the date of enactment or additional contributions are made after the date of enactment.

Planning Tip:
Most tax advisors believe the bill will ultimately be modified to allow for future gifts to life insurance trusts - for purposes of funding the insurance premiums. However, individuals with ILITs that require premiums early in 2022 should be considering alternative means of funding those premiums, if the changes in the law are not accommodative.

Sale to a grantor trust: A sale to a grantor trust of appreciated property today does not cause a recognition event (i.e., the gain is not recognized at that time). This proposal will change that. If the proposed bill is enacted into law, sales of assets by a deemed owner to his/her grantor trust would be recognized for federal income tax purposes to the extent of the deemed owner's portion of the trust.

Older grantor trusts: The provisions described above would also apply to grantor trusts established before the enactment date, where the trust's grantor then makes gifts (or sales) of property to those trusts. Doing so would cause the grantor's trust property to be includable in the grantor's taxable estate.

Valuation discounts: There will be restrictions and limitations on valuation discounts for non-business interests transferred to a grantor trust. In short - assume that valuation discounts are not available unless it's a share of a closely held family business.

Trust income taxation: Trusts are already subject to high-income taxes on income attributed to the trust (assuming it is a non-grantor trust) - hitting the highest tax bracket of 37% with just $13,051 of income. The proposal will increase those taxes.

Trust income will now have the Net Investment Income tax applied to them. This provision does not appear to have a minimum income limit - and so trusts with income over $12,500 (which appears to be a reduction from 2021's $13,051) will have a 39.6% income tax against them, along with the 3.8% NII tax (for a total rate of 43.4%).

CORPORATE INCOME TAX RATE

Businesses are going to be hit with higher tax rates. For businesses with income below $400,000, their tax rate will actually reduce to 18% - but for businesses above that threshold, the tax rate is going to increase from 21% to 26.5%.

RETIREMENT PLANS/ACCOUNTS

New required minimum distributions: For ultra-affluent taxpayers with IRA's (or defined contribution plans) that amount to greater than $10,000,000 combined – there is going to be a special required minimum distribution (RMD) triggered for them in years where their income is at least $400,000 (single) or $450,000 (married/joint). IRA's will be prohibited from owning investments only available to accredited investors.

The special RMD is going to be 50% of the amount over $10,000,000 (and assuming the client has income over $400,000 / $450,000) – with Roth dollars all required to be aggregated together FIRST, and then distributed, and if that's insufficient to meet the RMD requirement – then go to pre-tax balances.

Example:
$13 million in combined non-Roth retirement accounts = $1.5 Million RMD = $594,000 Federal income tax due.

In general, Roth IRAs are not subject to Required Minimum Distributions during an individual's lifetime. That would change, however, for high-income (as defined above) Roth IRA owners with total retirement account balances of more than $20 million.

More specifically, prior to completing the 50% RMD described above, such individuals would first have to complete a separate RMD by distributing the lesser of their:

- Total balances in all Roth accounts (Roth IRAs, and Designated Roth Accounts, such as Roth 401(k)s, Roth 403(b)s, etc.); or
- The amount necessary to reduce total retirement accounts to $20 million

Roth conversion rules will change (again): For high-income taxpayers, specifically those whose "adjusted taxable income" is over $400,000 a year filing single, or over $450,000 if married and filing jointly, the new tax rule is set to do away with Roth conversions in the year 2032.

According to the bill, "adjusted taxable income" would be equal to the taxpayer's taxable income, plus any deduction for contributions made to an IRA, without regard to any required minimum distributions due to high retirement account values.

The backdoor is closing: "Backdoor" Roth IRAs (a strategy where clients above the income limits can contribute money to a non-deductible IRA, and then immediately convert to Roth) appear like they will be eliminated. Conversions as a whole will only be allowed in years when the taxpayer has taxable income below the thresholds of $400,000 or $450,000.

IRA contributions go away for UHNW: Beginning in 2022, in any year in which 1) an individual's Adjusted Taxable Income exceeds their applicable threshold ($400,000 for single filers, $450,000 for joint filers); and 2) their total retirement accounts are worth more than $10 million, they will be prohibited from making IRA contributions.

Planning Tip:
Notably, though, the same restriction does not apply to employer-sponsored retirement plans, such as 401(k) plans. In fact, the restriction doesn't apply to SEP IRA or SIMPLE IRA contributions either.

YEAR-END NOTES

If you are having a hard time getting ahold of your estate planning attorney – it's because he or she is non-stop drafting grantor trusts for clients – so they can be executed and funded in 2021. Obviously, if you are an UHNW taxpayer and have not used your lifetime federal gift exemption, - to quote the ancient Roman poet, Virgil – "*fugit inreparabile tempus*": ("it escapes, irretrievable time"). If appropriate to your situation, gifts should be made as soon as practicable - particularly so the trustee can draft and send Crummey notices to the beneficiaries with at least 30 days to spare.

It should also be noted that the IRS itself can 'slow walk' the process of getting a Tax ID # for a trust if it gets too close to year-end. As I recall obtaining a Tax ID # for a new trust at the end of last year was challenging - in December the IRS shut down the ability to create new Tax IDs for the last 8 days of the year for "systems maintenance."

CONCLUSION

As always, consult professionals who can help you determine a strategy that is ideally suited for your personal situation.

Sincerely,

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Chief Operating Officer, Director of Planning
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