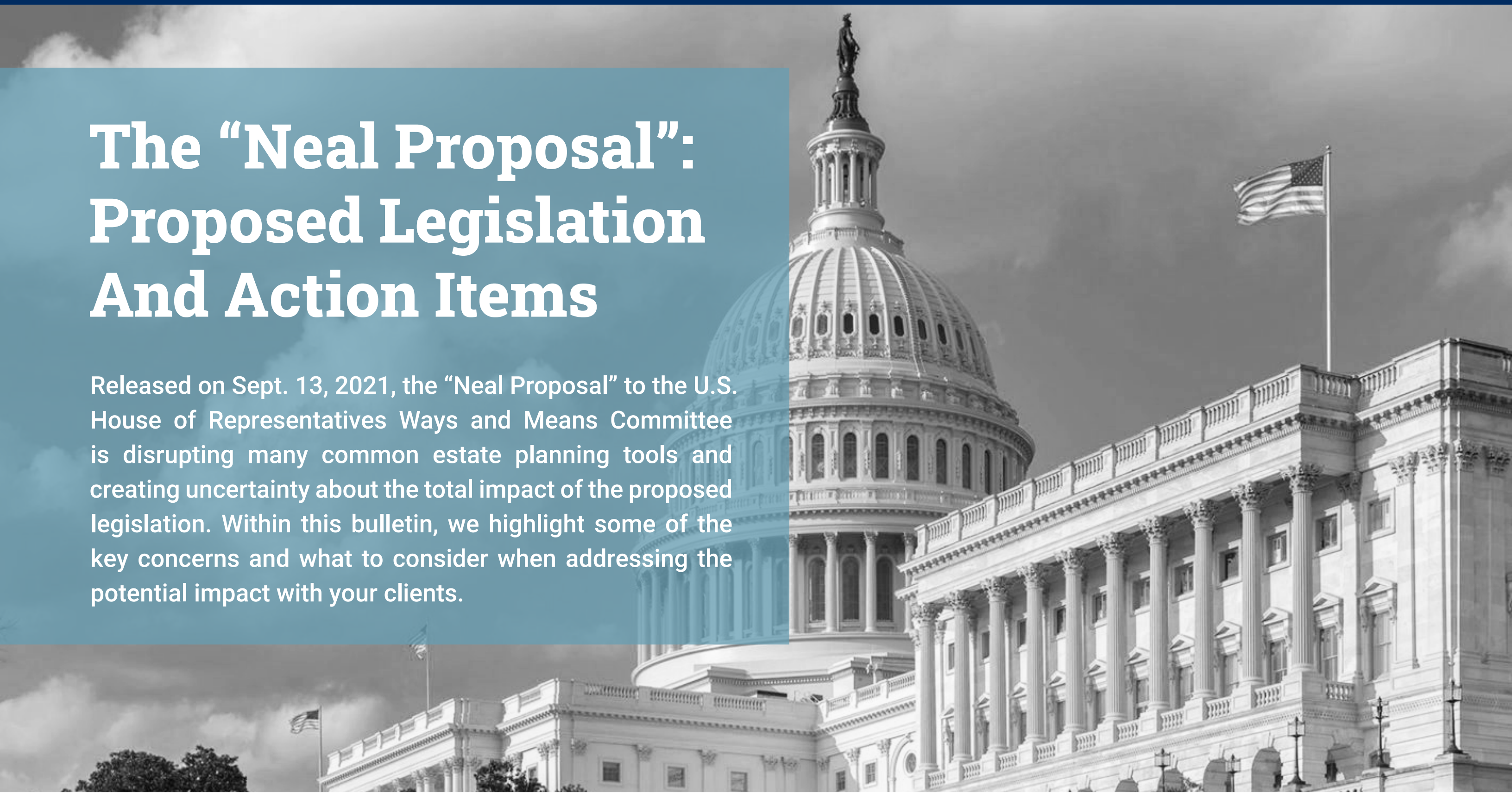
The “Neal Proposal”: Proposed Legislation And Action Items

Released on Sept. 13, 2021, the “Neal Proposal” to the U.S. House of Representatives Ways and Means Committee is disrupting many common estate planning tools and creating uncertainty about the total impact of the proposed legislation. Within this bulletin, we highlight some of the key concerns and what to consider when addressing the potential impact with your clients.



The House Ways and Means Proposal Reduces The Estate Tax Exemption

While likely not the final word, the Tax Cuts and Jobs Act (TCJA) temporarily doubled the basic exclusion amount (estate and gift tax exemption) from $5 million to $10 million per person, indexed for inflation. Currently indexed to $11.7 million, this was originally intended to “sunset” on Dec. 31, 2025. However, Bill Section 138207 causes the basic exclusion amount to revert to $5 million (indexed for inflation from 2011) for gifts made, or decedents dying, after Dec. 31, 2021. Additionally, because the Internal Revenue Code[1] (IRC) ties the Generation Skipping Transfer tax (GST) exemption to the basic exclusion amount, the GST exemption will also revert to $5 million, indexed for inflation from 2011. It is estimated that the gift, estate, and GST exemption (when adjusted for inflation) will be approximately $6 million.

Next Step: Act Now

The potential for an early reduction in the exclusion results in a “use or lose it” scenario for those high net worth clients who have not used all their basic exclusion amount through reportable gifts. Here are some steps they can consider:

Make gifts to Irrevocable Life Insurance Trusts (ILITs) to pay future premiums

- Most ILITs are deemed to be grantor trusts. Under the current tax proposals, grantor trusts existing prior to the date of enactment will be grandfathered under the current rules.
- However, gifts made to an existing grantor trust after the date of enactment may cause partial inclusion of trust assets in the estate of the grantor at their death.
- Where a review of trust-owned life insurance policies determines that additional premium is required, prefunding the trust (prior to the date of enactment) may reduce or eliminate the need for future transfers to trust.

For a more expansive explanation of the proposed changes to grantor trust taxation, contact your HORAN representative to receive a copy of our Advanced Market Insights: Proposed Legislative Changes Would Impact Use of ILITs In Estate Planning, issued Oct. 1, 2021.

[1] Unless otherwise indicated, all mentions of the Code or “IRC” are references to the Internal Revenue Code of 1986.

Unwind existing private split-dollar and other financed transactions

• Private split-dollar, commercial premium finance, and installment sales are all popular techniques to purchase life insurance and shift equity into trust on a tax-advantaged basis.

• Some clients may wish to apply their remaining basic exclusion amount to forgive or repay any outstanding debt and "unwind" these designs.

Establish new trusts and fund with large, reportable gifts

• Given the proposed changes to grantor trust taxation, careful consideration should be given to the trust's design.

• Clients are advised to consult counsel on the possibility of establishing a grantor trust.

Create A Grantor Trust Before It's Too Late

A "grandfathered" grantor trust may provide the client with added future flexibility. Section 138209 of the proposal would add IRC Sec. 2901, which provides that if the grantor is deemed to own trust assets for income tax purposes, they are also owned for transfer tax purposes and are part of the grantor's gross estate at death. Grantor trusts established prior to the proposed statute's effective date will be "grandfathered".

In the proposed section, the effective date is currently written as the date of enactment, not Dec. 31, 2021— meaning we do not know if, or when, this will happen. Importantly, future gifts to "grandfathered" grantor trusts will cause partial trust ownership on the part of the grantor, and partial inclusion in their estate at death.

Next Step: Establish and Fund A Grantor Trust

For clients with sufficient means, consider establishing and sufficiently funding a grantor trust prior to the proposed statute's enactment. While the situation is highly fluid and details are uncertain, it may still be possible to have a grantor trust drafted and funded prior to the effective date of the proposal. This could provide the grantor, or client, some flexibility not otherwise offered by non-grantor trusts, including the following:

Spousal beneficiary access

• The grantor may have indirect access to trust assets via a spousal beneficiary.[2] Understanding that the family unit may have access to trust assets via a spousal beneficiary may help the client become comfortable with transferring assets to trust.

Permit the trustee to apply trust income to pay for life insurance on the life of the grantor and/or their spouse3

• Particularly useful when the grantor gifts income producing assets to trust as a means of supporting future life insurance premium.

Grantor may borrow from trust without adequate interest or security4

• Like spousal access provisions, loan provisions may provide the grantor/client with added comfort in gifting assets to trust. Properly managed, this provision may provide the grantor access to trust assets without inclusion in their taxable estate at death.

• Ensure that any loan meets the standard of a legitimate and bona fide loan as defined by law. Failure to have a bona fide loan may risk estate tax inclusion under IRC Sec. 2036. Further, loan interest payments by the grantor to the trust may be deemed to be disguised gifts if the interest rate applied is too far in excess of the applicable federal rate, which could cause a partial "ungrandfathering" of the grantor trust.

Grantor's power to reacquire trust corpus by substituting other property of equivalent value5

• Generally regarded as one of the more useful provisions contained in grantor trusts, this allows the grantor to "swap" personal property with trust property of equivalent value without realizing gain or estate tax inclusion of trust assets.

"Toggle" provisions

• In order to provide added flexibility to convert to a non-grantor trust in the future, the trustee or trust protector should be given the right to terminate, or "toggle-off", all of the grantor trust enabling provisions.

[2] IRC Sec. 677(a)(1)
[3] IRC Sec. 677(a)(3)
[4] IRC Sec. 675(2)
[5] IRC Sec. 675(4)(C)

• These provisions should be carefully crafted to completely disable any provision which could cause the IRS to view the trust as a grantor trust. It is not enough for the grantor to avoid using the power.

Proposed IRC Sec. 1062 would create a taxable event for "any transfer of property between a trust and the person who is deemed owner of the trust (or some portion thereof)."

A literal reading of this provision would seem to indicate that asset swaps or sales between the grantor and their grandfathered grantor trust would not be subject to a tax realization event under the new law. However, the House Ways and Means Committee has indicated that they may change the effective date for this provision to capture any future sale or swap of assets between the grantor and their trust, irrespective of whether the grantor trust was grandfathered under the old law. That said, it does not appear that the mere existence of a substitution provision would cause tax consequences. It may be prudent to include these provisions in grantor trusts drafted prior to the date of enactment, while giving the trustee or trust protector the power to "toggle off" this and other grantor trust provisions.

Limitations On Valuation Discounts

Sec. 138210 of the proposal would replace the language in IRC Sec. 2031(d) restricting the availability of valuation discounts to business entities.[6] It would disallow valuation discounts on transfers of nonbusiness assets held by entities. In essence, this would eliminate valuation discounts on the transfer of interests in family holding companies (e.g., family LLCs or LLPs) where these entities are merely repositories for investible assets. Note: the effective date is the date of enactment, not Dec. 31, 2021.

Next Step: Transfer Income Generating Assets At A Discount

• To make use of any valuation discounts now, clients who have existing family LLCs or LLPs should consider transferring ownership interests either in trust (preferably, a grandfathered grantor trust), or directly to downstream younger family members.

• For clients who do not currently own funded LLCs or LLPs, caution should be taken in engaging in these transactions over the short term. The risk is that the IRS may apply the Step Transaction Doctrine in reviewing any of these transfers in an attempt to invalidate any discounts claimed by the taxpayer. Clients should consult with qualified legal counsel before attempting to create, fund, and transfer interest in business entities prior to the date of enactment.

• While transfers to a non-grantor trust are a viable option (for reasons described in the next section), non-grantor trusts may be subject to increased income tax liability on investment income.

Increases In Income Tax Rates For High Earners, Trusts, And Estates

Various elements of the House Ways and Means proposal increases income taxes on high earners, trusts, and estates. This includes an increase to the highest marginal income tax rate from 37% to 39.6%,[7] and an increase to the highest long-term capital gains and dividend tax rate from 20% to 25%.[8] Recall that taxpayers who find themselves in the highest marginal bracket would generally be subject to the Net Investment Income Tax (NIIT) 3.8% surtax on investment income.

In addition, the proposal creates a new 3% tax surcharge on high income individuals, trusts, and estates.[9] This

[6] Nonbusiness assets are broadly defined as any passive asset that is not used in the conduct of an active trade or business, but rather, is held for the production of income or investment return.

		Highest Rate	NIIT	PROPOSED SURTAX	TOTAL TAX	EFFECTIVE TAX INCREASE
ORDINARY INCOME	Current	37%	3.8%	N/A	40.8%	
	Proposed	39.6%	3.8%	3%	46.4%	~13.7%
LT CAPITAL GAIN/DIVIDEND	Current	20%	3.8%	N/A	23.8%	
	Proposed	25%	3.8%	3%	31.8%	~33.6%

surtax would apply to taxpayers with modified adjusted gross income (MAGI) in excess of $5 million for married filing jointly, $2.5 million for married filing separately, and $100,000 for trusts and estates.

The implication for non-grantor trusts

The implication for non-grantor trusts (or any trust that may become a non-grantor trust) is the potential for a significant increase in the tax rate. Trusts and estates reach the highest marginal income and capital gains brackets when they have taxable income in excess of approximately $13,000 (tax year 2021). For trusts with MAGI in excess of $100,000, they will also be subject to a 3% surtax.

Additionally, state and local taxes on trust investment income may push income tax rates over 50% depending upon the trust's domicile.

Permanent Life Insurance May Provide A Solution

For trustees of non-grantor trusts (or trustees of grantor trusts who anticipate future non-grantor trust status), consider using tax-advantaged investments and products to reduce MAGI. Municipal bonds or municipal bond funds may be attractive options, but for those who qualify, permanent cash value life insurance may be a viable alternative as a tax-efficient trust asset.

Cash value life insurance offers tax-deferred growth potential and income tax-advantaged access to cash values during life,[10] and an income tax-free death benefit.[11] For trustees and/or trust investment advisors who wish to have more exposure to the market, variable universal life (VUL) and private placement life insurance (PPLI)[12] may provide an opportunity to participate in the financial markets while maintaining the tax advantages offered by permanent life insurance.

To Be Determined...

The contents of this paper constitute our thoughts and understanding of the tax proposal's impact as of the date of drafting. Given the uncertainty around whether the tax proposals will be passed as drafted, and in what form, as well as their potential application if passed, these positions are subject to change. HORAN will continue to monitor the status of these proposals and analyze the impact to our clients and the broader planning community.

[7] Proposal Sec. 138201 changing IRC Sec. 1(j)(2); effective for tax years beginning after Dec. 31, 2021
[8] Proposal Sec. 138202 changing IRC Sec. 1(h)(1)(D); effective retroactively to sales occurring after Sept. 13, 2021, with the exception of sales subject to a written and binding contract entered into on or before Sept. 13, 2021
[9] Proposal Sec. 138206 adding IRC Sec. 1A; effective for tax years beginning after Dec. 31, 2021; It is unclear at the moment whether this 3% surtax would apply to long-term capital gains and dividends, but the expansive language of the proposal leaves the door open to this possibility.
[10] This assumes the policy passes the testing requirements of IRC 7702 and is not a modified endowment contract (MEC).
[11] IRC Sec. 101(a)(1); exceptions for transfers value (IRC Sec. 101(a)(2)), reportable policy sales (IRC Sec. 101(a)(3)), and certain employer-owned policies (IRC Sec. 101(j)).
[12] Must be an accredited investor to qualify.

Contact HORAN at 800.544.8306 if you have questions about the proposed legislative changes.

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