Planning for Changes to the Federal Estate and Gift Tax System

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Overview

I have received many questions recently on what the Congress might do to the federal estate and gift tax laws and the planning steps, if any, that can be taken now to prepare for changes. It's an important questions that many have, particularly farm and ranch families. It's also a topic that I will spend a good deal of time on during the summer conferences in Ohio and Montana. You can learn more about those conferences here: https://www.washburnlaw.edu/employers/cle/farmandranchtaxjune.html and https://www.washburnlaw.edu/employers/cle/farmandranchtaxaugust.html.

What has been proposed? Will it pass? Will valuation discounts be eliminated? What about the income tax basis rule at death – will it change?

The possible changing estate and gift tax (and income tax basis at death) landscape – it's the topic of today's post.

The Current Situation

The Tax Cuts and Jobs Act (TCJA) doubled the basic exclusion amount as well as the generation-skipping transfer tax (GSTT) exemption for years 2018-2025 to $10 million (in 2011 dollars). Starting in 2026, the exemptions revert to pre-TCJA law - $5 million in 2011 dollars. In other words, beginning in 2026, the exemptions will fall to $5 million but will be adjusted for inflation since then. But will we get to 2026 without the current exemptions being reduced before then? That's a good question that depends entirely on politics.

What if the exemption decreases? If the current Congress decreases the exemption, it's important to understand the "math" behind the computation of a decrease. Presently, the exemption equivalent of the unified credit for federal estate and gift tax purposes is $11.7 million. It was $5.49 million in 2017, before TCJA increased it to $11.18 million in 2018. One strategy to address a drop in the exemption might be to make gifts now while the exemption is at $11.7 million and use exemption to cover the taxes on the gifts. However, the way the IRS views the $11.7 million exemption is in two separate pieces. One piece is $5.85 million and represents the "old" exemption. According to the IRS, gifts made in 2021 use this part of the current $11.7 million exemption first. Then, for taxable gifts beyond $5.85 million in 2021, the other "piece" of the exemption (also equal to $5.85 million) is utilized. This piece represents the 2018 exemption increase. It is this piece that is lost if it is not used before the law changes that decreases the exemption. This assumes, of course, that any reduction in the exemption would take effect after 2021. A retroactive change would wipe out this planning strategy of making gifts now to use up the higher exemption.

Proposed Legislation – S. 994

Exemption and rates. Earlier this year, Senator Bernie Sanders proposed the "For the 99.5% Act." *S. 994.* The bill is currently in the Senate Finance Committee. A similar proposal was proffered in 2019 but didn't' go anywhere. Basically, the same proposal was made in the President's final proposed budget in

2016. The proposals all do essentially the same thing – set the federal gift tax exemption at $1 million without indexing for inflation; set the federal estate tax and GSTT exemption at $3.5 million; and retain portability of any unused exclusion amount. *S. 994, Sec. 2(b).* In terms of the tax rate structure, taxable estates exceeding $3.5 million up to $10 million would face a 45 percent rate. Taxable estates over $10 million up to $50 million would be taxed at a 50 percent rate. Those over $50 million but not over $1 trillion would be taxed at 55 percent, and those exceeding $1 trillion would be taxed at 65 percent. If enacted in its present form, the effective date would be for deaths, GSTT transfers and gifts made after December 31, 2021. *S. 994, Sec. 2(c).*

Special use valuation. For farms and ranches potentially subject to federal estate tax, electing special use valuation can be a viable estate tax planning technique if the elected land will be farmed by a family member (or members) for 10 years after the decedent dies. I.R.C. §2023A. For deaths in 2021, the maximum reduction in value of farmland subject to the election is $1.18 million. The proposal is to increase that amount to $3 million, effective for deaths after 2021. *S. 994, Sec. 3.*

Conservation easement. Under current law, land subject to a conservation easement can be excluded from estate tax up to $500,000 in value. S. 994 increases that amount to $2 million. It also increases the maximum percentage of the land which can be excluded from 40 percent to 60 percent. *S. 994, Sec. 4.* This provision would be effective for deaths and gifts after 2021.

Grantor trusts. S. 994 eliminates the current income tax basis step-up rule at death for property contained in certain types of grantor trusts. The provision applies to property held in a trust of which the transferor is considered to be the owner, and the property transferred to the trust is not included in the transferor's gross estate at death. *S. 994, Sec. 5.*

Valuation discounts. As for valuation discounts for such things as lack of marketability, minority interests, blockage, and built-in gain taxes, S.994 specifies that any assets of an entity that are not used in the active conduct of the trade or business that are transferred are to be valued as if the assets were transferred directly (i.e., non-actively traded interests). Likewise, "passive assets" are not treated as used in the active conduct of a trade or business*. S. 994, Sec. 6.* In addition, no discount for minority interest is allowed if the transferee and family members have control or majority ownership (for non-actively traded interests). *Id.* These assets are to be valued as if the transferor had transferred the assets directly to the transferee. *Id.*

Excluded from the definition of non-business assets are inventory and real estate rental activities involving a real estate professional where the 750-hour requirement has been satisfied. *See, I.R.C. §469(c)(7).* There is also an exception for working capital. *Id.* A "look-through" rule also applies with respect to non-business assets. This rule is designed to prevent any discount for non-business assets that are held in a lower-tier entity. A 10 percent ownership interest threshold applies for this purpose. If the rule applies, the upper-tier entity is treated as if it directly owns its ratable share of the lower-tier entity's assets. *Id.*

As for minority discounts, S.994 disallows them when the transferor, transferee and family members together have either control or majority ownership after the transfer of entity interests. "Member of the family" is defined in accordance with I.R.C. §2032A(e)(2). There the definition includes an individual's spouse and siblings, ancestors and descendants (including lineal descendants of the decedent's spouse or parent of the decedent), spouses of descendants, and lineal descendants and spouses of the decedent's spouse. For these purposes, a legally adopted child of an individual is treated as blood relation.

As a distinction from other parts of the legislation, the valuation rules would be effective upon date of enactment. *Id.*

Consider the following example illustrating the impact of eliminating (or severely restricting) valuation discounts:

Example: Snarkfeltcher Valley Farms (SVF) is a closely-held family farming operation owned by family members. The parents would like to transfer controlling interests to their son and daughter so that they can manage and control the family business after the parents retire and ultimately pass away. Presently, SVF has a fair market value of $12 million. With appropriate estate planning, upon the last of the parents to die with transfer of full operational control to the children, valuation discounts could be achieved. Under current law, the federal estate tax would be computed as follows (assume that all of the assets are used in SVF's trade or business):

Gross Value:	$12,000,000
Lack of marketability discount	$3,000,000
Minority interest discount:	$1,800,000
Net taxable value:	$7,200,000
Available exemption:	$11,000,000
Estate tax due:	$0

Now assume that S.994 becomes law and the transfer of control of SVF occurs after the law become effective. Here's how the federal estate tax would be computed:

Gross Value:	$12,000,000
Lack of marketability discount:	$3,000,000
Minority interest discount:	$0
Net taxable value:	$9,000,000
Tentative estate tax:	$3,795,800 ($1,320,800 + .45 x $5.5 mil.)
Less available credit:	$1.455,800 (credit that offsets first $3.5 mil.)
Estate tax due:	$2,340,000

Grantor-retained annuity trusts. An important business succession planning concept for some families is that of the grantor-retained annuity trust (GRAT). A GRAT is a technique that can allow the grantor to "freeze" the value of the transferred assets while simultaneously providing the grantor with a cash flow stream for a specified time-period. I have written about the use of the GRAT here: https://lawprofessors.typepad.com/agriculturallaw/2018/09/farm-wealth-transfer-and-business-succession-the-grat.html

S. 994 essentially eliminates GRATs as a planning strategy by imposing a minimum 10-year term, and a maximum term tied to the life expectancy of the annuitant plus 10 years. In addition, the remainder interest must have a value (as determined at the time of the transfer) that is not less than an amount that is equal to the greater of 25 percent of the GRAT's fair market value or $500,000, and not be greater than the fair market value of the property in the trust. *S. 994, Sec. 7.* These rules would be effective to transfer made after the date of enactment. *Id.*

Grantor trusts. S. 994 also makes changes to the rules governing grantor trusts. While assets in a grantor trusts are included in the grantor's estate for federal tax purposes, distributions from grantor trusts during the grantor's life are treated as taxable gifts. S. 994, Sec. 8. In addition, if at anytime during the life of the owner, the owner ceases to be treated as the owner of any of the trust assets, those assets are deemed to be a gift. *Id.* These changes would apply to trusts created after the date of enactment as well as to transfers made to pre-existing trusts after date of enactment and sales to pre-existing trusts. Apparently existing grantor trusts would be grandfathered.

GSTT. The proposed legislation specifies that the inclusion ratio of any trust other than a qualifying trust is pegged at 1. In addition, a qualifying trust must terminate not greater than 50 years after the trust is created. Also, pre-existing trusts must terminate within 50 years of enactment. *S. 994, Sec. 9.* Also, S. 994 eliminates the GSTT exemption for certain long-term trusts. *Id.*

Gift tax rule changes. S. 994 specifies that the first $10,000 of gifts made to a person during the calendar year are not to be included in the amount of gifts made during the year. *S. 994, Sec. 10.* The limit is $20,000 per donor. The transfers subject to this limitation include transfers in trust, a transfer of an interest in a pass-through entity, a transfer of an interest subject to a prohibition on sale, and any other transfer of property that, without regard to withdrawal, put, or other such rights in the done, cannot immediately be liquidated by the donee. *S. 994, Sec. 10.*

Client Relations

Given these proposed changes in federal estate and gift tax law, how should practitioners advise clients? For starters, the possible impacts on a client's estate plan of the proposed changes should be discussed. Perhaps a projection should be done of a client's estate value particularly in light of the changes in the valuation discount rules. Also, consideration should be made of the benefits of accelerating the funding of GRATs and other grantor trusts. In that vein, sales to an intentionally defective grantor trust (IDGT) may also need to be accelerated. I have discussed IDGTs here: https://lawprofessors.typepad.com/agriculturallaw/2017/07/using-an-idgt-for-wealth-transfer-and-business-succession.html and here: https://lawprofessors.typepad.com/agriculturallaw/2018/08/intentionally-defective-grantor-trust-what-is-it-and-how-does-it-work.html

Also, give consideration to using the lifetime federal estate/gift tax exclusion prior to the law's enactment (assuming that it does get enacted). That also means being prepared to make taxable gifts. Other thoughts should be given to the ordering rules surrounding the ordering rules for the deceased spouse unused exclusion (DSUE) amount.

Conclusion

The proposed changes in the rules governing federal estate and gift tax are creating many questions and concern. Knowing what the proposed changes might be is useful for purposes of evaluating the steps that can be taken to best handle the changes if they are enacted, and ensure that one's estate/business planning goals can be achieved. Again, I will spend a significant amount of time at the summer events in Ohio and Montana discussing these matters. Don't miss out. Attendance online is also possible.