

The Van Hollen Gains at Death, Gift or Distribution from a Trust Bill (STEP): Your World May be Rocked!



A KEY ESTATE
PLANNING GUIDE

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The Van Hollen Gains at Death, Gift or Distribution from a Trust Bill (STEP): Your World May be Rocked!



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Introduction

**Van Hollen/STEP,
Sanders and More**

Introduction

- Planning now in light of Van Hollen's STEP proposal, the Sanders' proposal, various income tax proposals and President Biden's comments.
- Inter-relationship of income tax changes, Sanders and Van Hollen is key.
- Republicans have come back with a reply to the infrastructure bill suggesting instead of raising taxes having user fees.
- We will discuss each of these, the constitutionality and end with discussion of practical planning implications.
- President Biden is to address a joint session of Congress shortly and we may get a better window into what might happen.

Income Tax Proposals

Income Tax, Capital
Gains, Social
Security

Income Tax Proposals

- Income tax increases on income over \$400,000.
- Impact on structure of business.
- Impact (with higher federal tax and state tax) on retirement, financial forecasts, etc.
- Restore the 39.6% marginal rate.
- Cap the itemized deduction tax benefit to 28%.
- Deductions less valuable.
- Restore the 3% PEASE limitation.
 - Reduced itemized deductions by 3% of AGI over the threshold, up to 80% of itemized deductions.
- New Section 199A Deduction Phaseout.

Capital Gain Increases

- 39.6% rate applied to capital gains over \$1,000,000. (Plus, maybe 3.8% for NIIT.)
- Eliminate the Basis “Step-up” at Death – Discussed later.
- Changes the dynamic of planning to retain appreciated assets if no step up but there may be no step up in basis at death.
- Use CRTs, gain/loss harvesting, and other techniques to smooth income below \$1 million to avoid the higher tax.

Expand Social Security Taxes

- Expand the 12.4% Social Security tax.

Deductions

- Reinstatement of the SALT Deduction.
- Not specifically proposed by President Biden, but an often-discussed Democrat agenda item.
- Reconsider state income tax minimization strategies – the calculus of INGs may change (compounded by IRS no ruling strategy). In Rev. Proc. 2021-3, Sec. 5, the IRS announced that INGs are under study and no new ING PLRs will be issued.
- Consider timing tax payments.

Overview of 2 of the Key Proposals

Sanders and Van Hollen

Sanders Overview

- Sanders' Bill "For the 99.5 % Act."
- Estate, gift, and GST tax rates would rise from 40% to 45% and up to 65%, effective next year.
- Estate and GST exemptions would be reduced to \$3.5 million and gift tax to \$1 million, effective next year.
- No minority/lack of control discounts for non-active business interests transferred if the family holds 50% or more in vote or value. Active businesses would continue to be valued as they have been except non-essential assets would be separately valued without discounts.

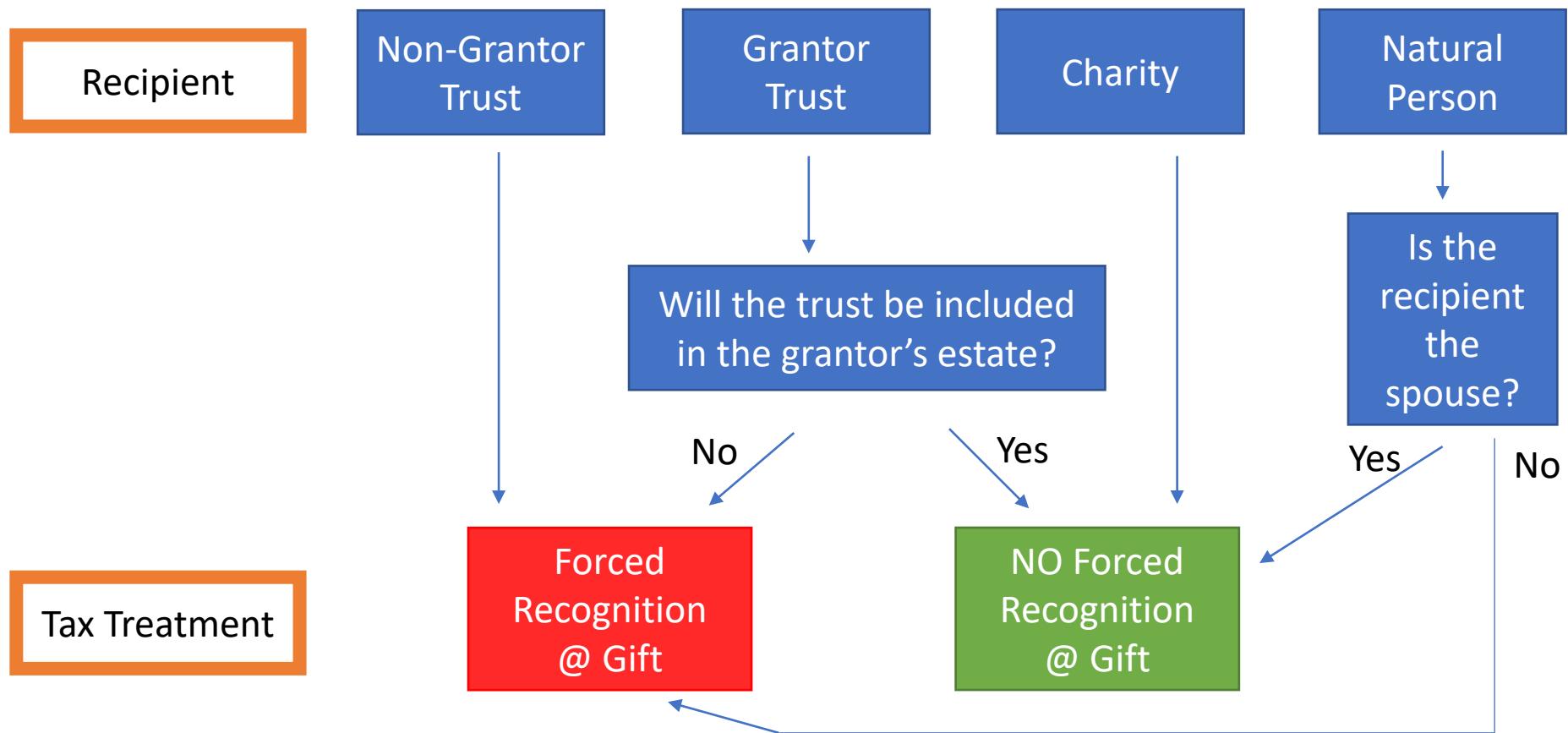
Sanders Overview

- GRATs would have to last for at least ten years and not longer than the grantor's life expectancy plus ten years, and the value of the (taxable) remainder would have to be at least 25% of the value of the assets contributed to the GRAT.
- Grantor trusts (other than those "grandfathered") would be included in the grantor's gross estate at death.
- GST exemption would last for only 50 years.
- Annual exclusions for transfers in trust limited to \$30,000 a year. Consider the ILIT complications.
- No step-up in basis for assets in a grantor trust unless in the grantor's gross estate. Why is this in the bill?

Van Hollen Overview - 1

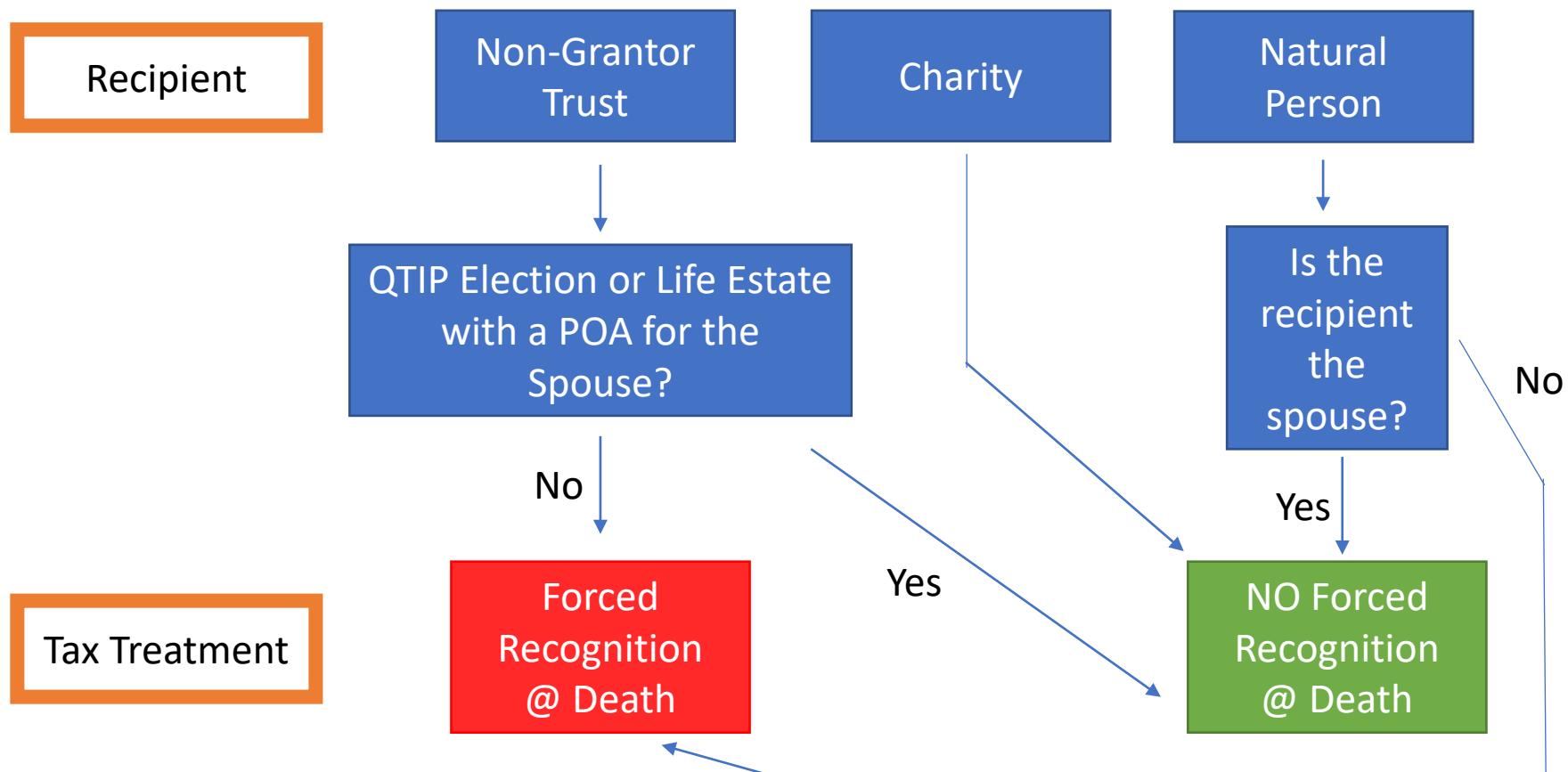
- Sensible Taxation and Equity Promotion (STEP) Act of 2021, announced March 29 by Senate Budget Committee member Chris Van Hollen, D-Md
- Transfers that are not income tax free may generally trigger income tax (capital gains) taxing all unrealized appreciation.
 - Gifts.
 - Transfers to non-grantor trusts.
 - Death.
 - Kind of like the Canadian system.
- Exclusions that avoid gain recognition.
 - Up to \$1 million of unrealized capital gains over lifetime and death.
 - Additional \$500,000 exclusion for transfer of a personal residences.
 - Limited exception for tangibles.
 - Donations to charity (but transfers to charitable trusts might not be exempt).
 - In some instances, assets held in retirement accounts.

Forced Recognition @ Gift



The STEP Act of 2021, Proposed New IRC 1261

Forced Recognition @ Death



The STEP Act of 2021, Proposed New IRC 1261

Van Hollen Overview - 2

- Income taxes paid under Van Hollen's proposal may then be deducted against any estate tax due to minimize double taxation.
- Assets held in a non-grantor trust will be deemed sold every 21 years triggering gain on any unrealized appreciation.
 - Trusts created in 2005 or earlier will be deemed to have gain triggered in 2026.
 - Note that in Rep. Pascrell (D. NJ) bill it would have a realization event every 30 years.
- STEP allows the income tax to be paid over 15 years when the realization occurs at death, but that's not the case for inter vivos gifts, which could also pose liquidity issues.
- Special annual reporting required for trusts.
- Effective to the beginning of 2021.

Van Hollen Overview - 3

- Five key planning situations.
- Transfer to a Nongrantor Trust – seems to be a realization event New - IRC Section 1261(a).
- Transfer to a Nongrantor Marital Trust - No Gain seemingly New - IRC Section 1261(c)(2).
- Transfer to a CRT – No gain under Senate bill New - IRC Section (c)(3)(B).
- Transfer to a Grantor Trust – if corpus not included in your Estate – seems to be a realization event. New – IRC Section 1261(b)(1)(A).
- Transfer to a Grantor Trust – Included in your Estate – No Gain until a triggering event occurs? New – IRC Section 1261(b)(1)(A).

Van Hollen Overview - 4

- Transfers to Grantor Trusts.
- If a transfer is made to a grantor trust an analysis of whether there will be estate inclusion under Code Section 2036, and hence no gain triggered under STEP, may be uncertain.
- What if you relinquish in a transfer to a grantor trust all 2036 strings? Are there situations in which it is not clear if all of a trust corpus is included? We do not know. So, you are taking a risk with any transfer because STEP is retroactive. The language in STEP “...would not be included” what does this mean?

Van Hollen Overview - 5

- Transfers to Grantor Trusts - Sale to grantor trusts and Swaps.
- A sale (e.g. typical note sale to a grantor trust) is not a transfer in trust but under Van Hollen's STEP act it may be treated as such.
 - If so, then Revenue Ruling 85-13 is effectively being repealed by the Van Hollen Act.
- Swaps to a grantor trust.
 - Are Substitution of assets treated any differently than a sale or other transfer? While it is not clear, it would appear not.

Van Hollen Overview - 6

- Transfers to Grantor Trusts - GRATs.
- Will GRATs work in light of the Van Hollen proposal? A transfer to a grantor trust is taxable under STEP if not included in your estate. The exception under STEP for transfers to grantor trusts says no gain must be recognized if all corpus is included in grantor's estate.
- If you use a GRAT and you make a portion taxable then it is not totally included in your estate. If you make a transfer to a GRAT and you die during the GRAT term and the 7520 rate rises then under the Regulations that govern estate inclusion less than all of the GRAT corpus will be included in your estate so does that suggest that a transfer to a GRAT would trigger taxable gain under STEP? Perhaps.

Van Hollen Overview - 7

- Transfers to Grantor Trusts – GRATs (continued).
- Under 2036 Regs put \$1M into a GRAT when 7520 rate is 1% so corpus would be \$1,010,000 in a year. Retain right to \$1,010,000 if you die its all included in your estate. If you die it might not all be included in your estate because 7520 rate has risen which will result in less in your estate. If 7520 rate rises to 5% only \$200,000 of corpus will be included in the estate, so it may be taxable. If amount in the estate is contingent on 7520 you do not know how Van Hollen will apply.
- What about the possibility of using a disclaimer in connection with a GRAT? Will that work? Some think not.

Constitutionality?

Will Proposals
Stand up to
Challenge?

Are The Proposals Constitutional?

- Cases.
 - Kaestner case.
 - Obama Care.
- Proposals.
 - Wealth tax.
 - Mark to market.
 - Gain at death or upon making a gift.
 - Carryover basis.

Using the Crystal Ball

What Might
Happen?

Speakers' Wild Guesses as to What Might Happen

- No one knows but here are the speakers' thoughts (which you should not count on coming true as our Ouija Boards are not working).
- Both -
- Elimination of carryover basis as a compromise of Van Hollen/STEP and Biden proposals.
- And a modified version of Sanders.
 - Restrictions on discounts, GRATs, and other techniques which many view as abusive.
 - Reduction in exemption, but perhaps not to \$3.5 million.
 - Increase in rates, but perhaps not to 65%.

What Planning Might You Suggest To Clients Now?

Can You Still Plan?

What Planning Might be Done Now – Income Tax?

- Income tax planning.
- Biden Thursday will propose doubling capital gains rate. If so, taking gains in 2021 may not be a negative it might be positive to intentionally trigger a gain under Van Hollen and shifting assets out of the estate.

What Planning Might be Done Now – Income Tax?

- Gain Harvesting before a 39.6% tax rate.
- Planning for No Step-Up in Basis.
- Loss Harvesting.
- Advanced Security Strategies.
- Charitable Remainder Trusts.
- Charitable Lead Trusts.
- Donating Capital Gain Property.
- Installment Sales.
- Opportunity Zones.
- Section 1031 Exchanges.

What Planning Might be Done Now – Estate Generally?

- The key issue is whether all planning is dead for the rest of the year.
- Make transfers to use exemption, lock in discounts, etc. but endeavor to minimize risks, although there is no assurance that these techniques, especially for income tax purposes, will be effective.
- Gift only cash (borrow if you have to) to avoid gain recognition if a Van Holland like bill is enacted. If not use a swap power to swap in other assets (and then repay the loan).

What Planning Might be Done Now – Estate Generally?

- Use Disclaimers.
- Consider Recission.
 - Why not add rescission provision and disclaimer to any transaction completed in 2021? You cannot be certain that it will not come back to bite. While it would appear that a disclaimer mechanism might work for transfer tax purposes (e.g., a retroactive reduction in the exemption) it is not clear for income tax that it will be effective. The effectiveness of a disclaimer or rescission for income tax purposes is uncertain.

What Planning Might be Done Now – Marital Trust Technique?

- Transfer to a Marital trust with disclaimer.
- This is an idea proposed by a well-known estate planner (but we were not sure she would want her name mentioned).
- For clients for whom this will work it seems to be a clever idea that should work.
- Consider using an installment sale transaction.
- Make an installment sale to a Code Section 2523(e) trust for the benefit of spouse. This is a Life estate with power of appointment in the donee spouse. The spouse is entitled for life to all the income from the entire interest, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse.
- There is no gain recognition under Van Hollen's proposal since there is an exception for a marital trust (but the spouse must be a US citizen).

What Planning Might be Done Now – Marital Trust Technique?

- The spouse/beneficiary can disclaim all her interests in the trust if a Van Hollen like proposal is not enacted, or if it is enacted it is not retroactive (or is effective after the date of the transfer by sale). The disclaimer pushes assets into a descendants' trust.
 - Perhaps someone can have a LPOA to add back the spouse.
 - Perhaps someone can have a SPAT provision to add back the settlor.
- If STEP is enacted leave the assets in the marital qualifying trust and it is not a recognition event under STEP.
- This will not work for every client. This only works because STEP has an exception for marital trust transfers (but only to a US spouse).

Conclusion and Additional Information

Lots of Uncertainty
Lots of Opportunity



Conclusion

- The tax environment may change dramatically.
- Much uncertainty remains.
- All high-income clients should review income tax planning options now.
- All wealth (defined by what might be a much lower exemption and harsher transfer tax system) clients should plan now, but with caution, consideration to the uncertainty, and the proposals presently known.

Additional information

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