ROCHESTER BUSINESS JOURNAL
GUIDE *to* WEALTH MANAGEMENT

Tax Changes

The Build Back Better Act is dead: Now what?

By Martin W. O'Toole | *Published in the March 18, 2022 issue.*

PROFESSIONAL OPINION

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For a piece of legislation that, as proposed, is dead, consideration of the potential federal estate, gift, and generation-skipping transfer ("GST") tax changes in the Build Back Better Act ("BBB Act") is not an exercise in idle speculation. Coupled with the Biden administration's proposal to change the treatment of lifetime gifts and transfers at death for capital gains purposes, those concerned about the impact of transfer tax and income tax on estate planning should not overlook the possible impact of the changes. Indeed, as discussed below, one of the changes — *future* reduction in the exemption against the estate, gift and GST tax — is already part of the Internal Revenue Code.

But first to avoid confusion, it is necessary to state which version of the BBB Act is under consideration. As the tax provisions for the BBB Act originally emerged from the House Ways and Means Committee, there was a decrease in the exemption against the estate, gift and GST tax (from, rough and ready, $12 million to $6 million) that would have been effective January 1, 2022, and provisions relating to the estate and gift tax treatment of "grantor trusts."

What is a grantor trust? In a nutshell, a grantor trust is not a separate taxable entity from the grantor; rather, the person who is considered the grantor reports the income, deductions and credit of the trust on the grantor's personal income tax returns. Through careful planning, it is possible to have grantor trust status but also have the trust not be subject to estate tax when the grantor dies. The initial provisions in the BBB Act would have largely eliminated this planning opportunity.

As the BBB Act emerged from the House Rules Committee, however, these changes were not included. That said, the decrease in the estate, gift and GST tax exemption is already scheduled to occur on January 1, 2026.

Turning to the Biden administration's capital gains proposal, the most significant change was to treat a gift or transfer at death as a deemed sale, generating gain. The change in basis for most assets as a result of the owner's death (the so-called "step-up" in basis) would have been eliminated.

So, what to do now?

In reviewing estate plans, clients and their advisors should consider the impact of both changes on the planning, particularly with respect to paying additional estate tax and capital gains tax. While considerations of liquidity have vanished for many estates, that consideration has re-emerged.

For anyone using a grantor trust, consideration should be given to what would happen if the original BBB Act proposal became law. Should the planning involve "non-grantor" trust status, that is, the trust's income is not reportable by the grantor? If planning does involve grantor trust status (which in the past often made good estate planning sense), should a provision be included in the trust agreement that would allow grantor trust status to be turned off?

In the last quarter of 2021, I saw many clients take steps to use the transfer tax exemption before its proposed reduction at the beginning of this year. For many, the planning was not completed when it became clear that the exemption would not be reduced. The impetus for use of the exemption is still present, it has just been deferred to 2026. Given the complexities of making taxable gifts, the deferral of the reduction provides an opportunity for less hurried thinking.

Be sure to consider the effects of inflation. For certain estate planning techniques (qualified personal residence trusts and grantor retained annuity trusts, to name two), the beneficial interest retained by the grantor must be valued. Why? The value of a gift is the value of the assets transferred less the value of the grantor's retained interest. The valuation of the retained interest requires an assumed rate of return; the methodology involves a basket of government securities. As inflationary expectations result in increased interest rates for government securities, the value of the retained interest increases, decreasing the value of the gift.

Increased inflation cuts both ways, however. For planning that involves making loans to children or other donees, an increase in interest rates makes the planning more expensive. Moreover, by deferring making a gift, the increase in the value of an asset owing to inflation will result in the use of more federal gift tax exemption.

For anyone who implemented an estate planning technique in anticipation of a reduction of the exemption and is now experiencing "donor's remorse," it may be possible to unwind the technique. The typical means is a disclaimer of the benefits by the donees. There is a timing consideration (under the federal gift tax, disclaimers must be made within nine months of the gift) and consideration of who receives the assets if a disclaimer is made.

For those contemplating future gifting, consideration should be given to including provisions that would allow some alteration of an ostensibly irrevocable gift. While such provisions may not result in the assets being returned to the donor, at least without adverse estate tax consequences, the provisions may mitigate the loss of flexibility to deal with future circumstances (say, a donee's creditor issues) that is part of an irrevocable gift.

Clients are well advised to retain basis information for their investments and, to the extent that there is missing information, take steps now to determine that information. Quite simply, this is more easily done when the owner is alive.

As clients consider making gifts with assets other than cash, the basis of the asset given, and the assets retained, should be considered.

Of course, there is a danger in assuming that the proposal that may never be enacted does, in fact, become law. By at least planning for the possibility, however, there should be less surprise if the legislative planets align and the Biden administration's capital gains proposal is enacted.

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