

Publications

The Potential Changes to Estate and Gift Tax Exemption, Grantor Trust Rules and Valuation Discounts

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The U.S. House of Representatives Ways and Means Committee recently released a new tax proposal known as the “Build Back Better” Act. The proposal, if signed into law, would significantly change the current estate and gift tax exemption amount and the grantor trust rules. This article summarizes the major proposed changes, the impact of the proposed changes, and the would-be effective dates of the proposed changes.

Estate and Gift Tax Exemption

Currently, the estate and gift tax exemption is \$11.7 million per taxpayer (\$10 million, as adjusted annually for inflation since 2011). As of today, the estate and gift tax exemption is scheduled to return to one-half of the current value as of January 1, 2026. However, the proposal seeks to accelerate the 50% reduction as of year-end. Thus, beginning on January 1, 2022, the estate and gift tax exemption would decrease to \$5 million per taxpayer (adjusted annually for inflation since 2011, or approximately \$6 million per taxpayer). If the proposal in its current form becomes law, each taxpayer would only have until year-end to take advantage of the additional \$5.7 million of gift tax exemption afforded to taxpayers this year.

However, it should be noted that you would need to make gifts in excess of \$6 million dollars for your gift to be impactful from an estate tax savings standpoint. For example, let’s assume you have a \$21.7 million estate, at the beginning of 2021 you have not used any of your \$11.7 million exemption, you make lifetime gifts totaling \$6 million in 2021, and you pass away on January 1, 2022. When the exemption is reduced to \$6 million on January 1, 2022, you would be considered to have used all of the reduced exemption and you would have no available exemption at your death. So, your estate would not be further reduced, and you would pay the 40% estate tax on a \$15.7 million estate, resulting in a \$6.28 million estate tax bill.

Now assuming the same facts, let's say you make lifetime gifts totaling \$11.7 million before year-end and then pass away on January 1, 2022. As of January 1, 2022, you will have used all of the current exemption and you would have no available exemption at your death. However, you would have reduced your taxable estate by \$11.7 million instead of only \$6 million. You would pay the 40% estate tax on a \$10 million estate, resulting in a \$4 million estate tax bill. By maximizing your gifts in 2021, you saved \$2.28 million in estate tax.

Bottom line: If you plan to make substantial lifetime gifts in order to decrease your taxable estate, now is the time to act.

Grantor Trust Rules

Under current law, certain irrevocable trusts can be drafted in a manner that allows the grantor (i.e., the donor of the gift) to remove the assets gifted to the trust from the grantor's taxable estate while remaining personally responsible for the income tax associated with the trust's assets. The major advantage to this planning technique is that the trust's assets are not depleted as a result of income tax payments since the grantor is using personal assets to pay the tax. This allows the trust assets to grow (outside of the grantor's taxable estate) and allows the grantor to reduce the size of the grantor's remaining taxable estate without making additional taxable gifts.

The proposal eliminates the benefit of grantor trusts as of the date of enactment. Under the proposal, the grantor of a grantor trust will be treated as the owner of such a trust for estate tax purposes, and the assets of such trust will be included in the grantor's estate.

The proposal extends to grantor trusts created on or after the date of enactment and to transfers made to such grantor trusts. Grantor trusts created prior to the date of enactment are grandfathered and would retain their tax benefits. However, the proposal attacks transfers made to grandfathered trusts on or after date of enactment. Thus, if the grantor of a grandfathered trust makes a gift to such trust, a portion of such trust is included in the grantor's estate for estate tax purposes.

Bottom line: Given that the enactment of the proposed laws could be imminent, if you are considering making a gift to an existing grantor trust or creating and funding a new grantor trust, it may be advisable to complete those gifts expediently, before the new rules would eliminate important tax benefits.

Valuation Discounts

Currently, when a gift of a minority or non-controlling interest in a private entity is made, the value of such gift can be discounted (i.e., reported at a lower value) to account for the lack of control, liquidity and marketability of the interest gifted. For example, you have a 15% interest in a closely-held limited liability company with a total value of \$10 million. You get an appraisal of the interest for gift tax purposes and the appraisal assesses a 30% discount for lack of control, liquidity and marketability. Thus, instead of your interest being valued at \$1.5 million for gift tax purposes, the interest is valued at \$1.05 million for gift tax purposes, taking into account the applicable discounts.

The proposal would eliminate a taxpayer's ability to discount the value of an interest in a minority or non-controlling private entity that holds publicly traded securities, non-operating cash or other passive, non-business assets as of the date of enactment.

Bottom line: If you are considering making a gift of an interest in a private entity that holds publicly traded securities, non-operating cash or other passive, non-business assets, it may be advisable to do so as soon as possible to take advantage of the current discounts.

Conclusion

Given the looming effective dates of the various proposed tax law changes and the significant tax implications that could result, you should contact your Vorys estate planning attorney for counsel regarding how these proposed tax changes could affect your estate and whether any immediate action is advisable.