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PRIVATE WEALTH MANAGEMENT | ARVEST

ESTATE PLANNING IMPACTS OF PROPOSED LEGISLATION

Details on The Latest Tax & Estate Planning Legislation From The House Ways and Means Committee

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This legislation is a proposal reported out of the House Ways and Means Committee, to be voted on by the full House by the end of September. If it passes, it will then be sent to the Senate, where they will likely pass a slightly different bill. The two bills will then be reconciled in a joint committee of select House and Senate members. The compromise bill will then be voted on by both bodies, and if passed by both the House and the Senate and subsequently signed by the President, it will become law.

What does the draft legislation propose?

It is an exhaustive piece of tax legislation used to pay for the $3.5T Budget Reconciliation passed earlier this year. Some of the major provisions are as follows: The 39.6% annual income tax rate is restored for single individuals making over $400,000 and married couples making over $450,000. The 20% capital gains rate for those same people will be increased to 25%. The 3% net investment income tax will be expanded for individual taxpayers with more than $400,000 of income or $500,000 if filed jointly. It will now cover income derived in the ordinary course of business but will not apply to income that FICA has already been imposed. This amends section 199A by setting the maximum allowable deduction at $400,000 for an

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individual and $500,000 for couples filing jointly. It makes permanent the excess business loss limitation, which limits pass-through business net losses and could offset non-business income to $250,000 if filing individually or $500,000 if filing jointly. This would create a new high-income surcharge equal to 3% of the excessive modified adjusted gross income (AGI).The AGI threshold is $5M for individual income and $100,000 for income of a non-grantor trust. There would be a termination of the temporary increase in the Applicable Exclusion Amount, which would be approximately $6M in 2022 and would apply to deaths, generation-skipping transfers, and gifts. The 2032A special valuation reduction for farms or businesses based on its current use rather than its highest and best use, would be increased from $750,000 to $11.7M, and then indexed for inflation.

The legislation would require that assets held in grantor trusts be included in the grantor's estate except those assets that were already in the trust prior to the enactment of this bill. Distributions from the grantor trust during the life of the grantor are gifts. The deemed ownership is disregarded whether the transfer is a sale or exchange, and any sale to a grantor trust will be fully recognized. The legislation would eliminate valuation discounts for non-business assets. The non-business assets of an entity transferred are valued as if the asset were transferred directly. Non-business assets are defined as any asset not used in the active conduct of a trade or business. (Certain passive assets can be treated as business assets if used in the active conduct of a trade or business.) For carried interest, the holding period for which a taxpayer must qualify for capital gain treatment was increased from 3 to 5 years.

Special rules are created for those who have high retirement plan balances, but only if they are high-income taxpayers whose annual income will exceed $400,000 as an individual or $450,000 if filing jointly. If any of these taxpayers have any retirement contributions exceeding $10M, no additional contributions can be made. In addition, for those taxpayers with large retirement plans between $10-20M, they must take a 50% distribution of the excess. For those

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taxpayers with a retirement plan over $20M, a 100% distribution of the excess must occur until the plan is below $20M, and then the 50% distribution rule applies. The proposal changes the IRA Self-Dealing Rules; currently an IRA cannot invest in a business entity in which an IRA owner holds a 50% or greater interest. The legislation would reduce the threshold to 10% for investments which are not tradeable on an established securities market. The bill clarifies the purposes of the Prohibited Transaction Rules. The IRA owner, as well as the beneficiary of an inherited IRA, is always a disqualified person.

A graduated corporate rate structure would replace the flat 21% rate of C corporations, with the highest rate being 26.5%. The legislation would allow eligible S corporations to reorganize as partnerships, income-tax free. Lastly, there are limitations on the special rules for 1202 Small Business Corporation Stock Sales (sometimes referred to as QSBS) and caps the exclusion to 50% if the taxpayer's AGI exceeds $400,000 if an individual or $450,000 if married, filing jointly.

Who is supporting this bill?

The bill is reported out of the House Ways & Means Committee on a straight-party line vote, with all Democrats voting for it and all Republicans voting against it. The biggest issue to its passage in the House is whether any moderate Democrats will vote against it, as they can only afford losing 4 votes.

When would the changes take place?

Most of the provisions will be effective on January 1, 2022, but two notable provisions would be effective upon date of enactment. Grantor trusts would be includable in the grantor's estate on the date the bill is enacted, but any contributions to such a trust would be outside the estate unless additional contributions are made. The new discount rules for non-business assets would also be effective on date of enactment, but any gifts, deaths, or generation-skipping transfers would be governed by the pre-existing valuation rules.

What are some of the most significant tax/exemption changes?

The increase in the highest marginal tax rate may change the long-held traditional view on whether it's better to accelerate deductions and defer income; it may make more sense to do just the opposite. Deductions are more valuable at a higher income tax rate, so it may make sense to defer deductions, if possible, to 2022. Income is just the opposite, and accelerating income to 2021 taxed at 37% as opposed to 39.6% may be warranted. Capital gains harvesting is also stood on its head; for those taxpayers holding appreciating assets that they intend to sell prior to death may want to consider selling them this year at a 20% rate as opposed to later years at a 25% rate.

Estate planning has become much more complicated; those with a net worth of $10M or more should consider making taxable gifts for one or both spouses so they don't lose the exemption that is likely going away. A Spousal Lifetime Access Trust (SLAT) should be considered immediately before the grantor trust rules change. For example, a grantor spouse who is older and less healthy can transfer $11.7M into a SLAT and make the younger spouse a discretionary beneficiary. The $11.7M will be covered by the grantor spouse's applicable exclusion amount and that amount plus all growth will be outside that grantor's estate. In addition, for larger estates, clients should consider funding the SLAT with discountable assets. This can supercharge the SLAT so that much more is outside the grantor and beneficiary spouses' estates.

Clients with assets expected to appreciate substantially in value and have significant cashflow associated with them should consider the use of Grantor Retained Access Trusts (GRATS) or sales to defective trusts before Congress eliminates them. For example, a client with $10M in an LLC whose assets produce a 10% rate of return and a 3% capital growth rate may be able to gift $7M to a 10-year GRAT, paying the grantor 10% per year and incurring no gift tax liability. At the end of 10 years, $28M would transfer to his/her beneficiaries tax-free. But, to accomplish this, the assets contributed must be valued and gifted to the GRAT prior to the enactment of the legislation.

Lastly, clients should consider strategies to reduce their taxable income to under $450,000 this year and in subsequent years, especially if they have IRAs or retirement plans valued over $10M. Some of the ways this can be accomplished is by the creation of split-interest charitable trusts, like Charitable Remainder Trusts (CRTS) or Charitable Lead Trusts (CLTS), which give a much higher charitable deduction that can be taken in one year but can be carried forward for 5 additional years.

How will this impact existing planning techniques?

Many planning techniques will be eliminated if the bill passes as currently proposed. The use of Family Limited Partnerships (FLPS) will no longer be of any value unless the assets are used in an active trade or business. But, since these new restrictions on discounts only apply to entities, it may be possible to give fractional interest discounts (generally in the 15% range) for partial interest in the asset itself. It is best to make the gift of a discountable asset today, before the law changes. Sales to defective trusts are ill-advised after the law is passed, as the assets inside the grantor trust will be subject to estate tax and the sale will be recognized when made. Consider instead, the use of private annuities or self-cancelling installment notes, where you can spread the tax over a period of years and, if done correctly, remove the asset from the estate.

The use of GRATS going forward is a more open question. The proposal did not have a 10-year minimum or a minimum gift component, but it does say that transfers from a grantor trust would be subject to gift tax. This would seem to eliminate the use of GRATS as an effective planning strategy, but until we have Treasury guidance, this is unclear. If a GRAT makes sense for a client, it makes sense to do it prior to the enactment of the legislation. An alternative to a GRAT would be a preferred partnership freeze, where the common interest could be gifted to a dynasty trust. This is more complicated, but if the growth of the asset exceeds the preferred interest, it could work just as well as a GRAT.

The last strategy that is affected, is the use of an Intentionally Defective Grantor Trusts (IDGTS). Assets inside such trusts will be grandfathered in and not be included in the grantor's estate if no additional contributions were made. For IDGTS that have life insurance in them that need continuing premium payments, gifts could cause the death benefit to be subject to estate tax of the insured.

Maybe the most perplexing aspect of the change in grantor trust rules is whether a SLAT is still a viable strategy. For SLATS to work going forward they need to be non-grantor trusts, which would mean that annual distributions to the spouse would need to be made to avoid substantial income liability at compressed rates. This makes it much more difficult to transfer substantial assets to the remainder beneficiaries. If a SLAT strategy is appropriate, it should be created before the new law is enacted.

A better strategy would be to make loans to the trust which would not cause estate tax inclusion. The bottom line is that estate planning starting in 2022 will be substantially different than it is today if these changes are passed. We will need Treasury guidance on a lot of unanswered issues, but suffice to say, if this bill passes it would be "the shot heard round the (planning) world."

What should clients do to prepare for these changes?

For those who are concerned about leaving the greatest amount possible to their heirs (and the least amount possible to the federal government), planning must begin today. The decreased exemption amounts are scheduled to be effective on January 1, 2021, but more importantly the new rules regarding grantor trusts are scheduled to be effective upon enactment of the legislation.

ADVANCED PLANNING TEAM

apt *adjective*, definition:

1 : unusually fitted or qualified
2 : suited to a purpose:
3 : keenly intelligent and responsive

The Arvest Private Wealth Management Advanced Planning Team is a group of highly trained professionals who are organized to strategically address financial planning issues and create strategies in the advanced areas of wealth management for clients with complex financial planning needs. The team focuses on helping clients build, manage, protect and transition wealth with coordinated solutions designed to navigate the many dimensions of wealth planning.

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