

Transfer Taxes Remain Unchanged

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A. Introduction

In our issue 2021-7, we mentioned that the House Ways and Means Committee's proposed tax provisions contained changes in the rules for grantor trusts, including grantor retained annuity trusts (GRATs) and sales to grantor trusts (IDGTs). In addition, a new subsection (d) of IRC Sec. 2031 was proposed to deal with the valuation of certain transfers of nonbusiness assets. These changes were included in the bill reported out of the House Ways and Means Committee. However, they were not included in the bill passed by the House.

In the Senate, tax proposals of the Senate Finance Committee were published and made available on December 11, 2021 and have none on transfer taxes. As a result, when (and if) legislation is passed and signed by the President, no transfer tax provisions will be included unless last-minute changes are made.

On December 19, 2021, Senator Joe Manchin announced his opposition to the Build Back Better Act (H.R. 5376). As a result, the legislation appears unlikely to move forward as a whole soon.

The applicable exclusion amount (AEA) for transfers made on or after January 1, 2022 will be \$12.06 million. The exclusion from the GST tax is also \$12.06 million.

This article will comment on the provisions originally included in the House Ways and Means Committee bill and why they were not passed by the House or proposed by the Senate Finance Committee and will also discuss other matters.

B. House Ways and Means Committee Bill

Two new sections were proposed to be added to the Code. One section was 2901 and the other section was 1062. These provisions will be referred to as "2901" and "1062." 2901 is primarily addressed to grantor retained annuity trusts (GRATs). 1062 is primarily addressed to sales to grantor trusts (IDGTs) and would negate Rev. Rul. 85-13, 1985-1 C.B. 184, which holds that a taxable transaction does not occur from a grantor's purchase of stock from a grantor trust.

2901(a) states:

APPLICATION OF TRANSFER TAXES.

(a) IN GENERAL.—In the case of any portion of a trust with respect to which the grantor is the deemed owner—

(1) the value of the gross estate of the deceased deemed owner of such portion shall include all assets attributable to that portion at the time of the death of such owner,

(2) any distribution (other than to the deemed owner or the deemed owner's spouse) from such portion to one or more beneficiaries during

the life of the deemed owner of such portion (other than in discharge of an obligation of the deemed owner) shall be treated as a transfer by gift for purposes of chapter 12,

(3) if at any time during the life of the deemed owner of such portion, such owner ceases to be treated as the owner of such portion under subpart E of part 1 of subchapter J of chapter 1, all assets attributable to such portion at such time shall be treated for purposes of chapter 12 as a transfer by gift made by the deemed owner, and

(4) proper adjustment shall be made with respect to amounts so included in the gross estate, or treated as transferred by gift, pursuant to paragraph (1), (2), or (3), as the case may be, to account for amounts treated previously as taxable gifts under chapter 12 with respect to previous transfers to the trust by the deemed owner.

Subsection (b) contained an exception which states that subsection (a) will not apply to any trust includible in the gross estate of the deemed owner.

Subsection (c) defined a deemed owner as "any person who is treated as the owner of a portion of a trust under subpart E of part 1 of subchapter J."

2901 was first proposed in S. 309 introduced by Senator Sanders in the Senate on January 31, 2019. See pages

13801-13803 of the January 2020 issue of Practical Drafting.

1062(b) is captioned "Certain Sales to Grantor Trusts." Subsection (a) states:

IN GENERAL.—In the case of any transfer of property between a trust and the a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.

Subsection (b) contained an exception for fully revocable trusts and subsection (c) had the same definition of "deemed owner" as is discussed above in connection with 2901.

The most abusive case "caught" by 2901 is a "zeroed-out" GRAT in which the grantor creates a trust and retains an annuity interest with a present value equal to the full value of the trust property. If the grantor survives the term of his or her retained interest, the then value of the trust property will pass free of gift tax to selected beneficiaries, provided the rate of return during the trust term exceeds the IRC Sec. 7520 rate at the creation of the trust. The GRAT is, in a sense, a no-lose proposition. In a period of low interest rates (such as has been the case in recent years) and a rising stock market, GRATs have avoided transfer taxes on very large amounts. For the most part, this result has been achieved as a result of a change in the tax law which led to the enactment of IRC Sec. 2702 and abolished the ability of the grantor, in making lifetime gifts, to subtract the value of a retained income interest in determining the value of the gift. The change has made the situation worse rather than better as to tax revenue.

The AICPA criticized 2901 and said the provision "is drafted too broadly and may affect more trusts than intended." This criticism was true because of the definition of deemed owner to include all trusts subject to IRC Secs. 671-679. The discussion of 2901 by the Joint Committee staff did not include an individual discussion of each of the sections referred to and thus the scope of the provision was uncertain.

IRC Sec. 675 lists certain administrative powers which, if held by the grantor or a "nonadverse party," result in the grantor being taxed as the owner of the trust. If it is deemed to be applicable, a number of issues arise. For example, what if an otherwise nongrantor trust makes a noninterest paying loan to the grantor and the loan is paid off after a few months? Under IRC Sec. 675(3), the loan will cause all or a portion of the trust to be treated as a grantor trust. When the loan is paid off, the trust ceases to be a grantor trust and, as a result, a gift tax would appear

to occur on the full value of such trust or portion of it. This result is troublesome and uncertain in effect. Consider also IRC Sec. 675(4) and the use of an advisor who acts in a non-fiduciary capacity. See Schoenblum, *The Nonfiduciary "Trust,"* 46 ACTEC Law J. 357 (2021).

An article, *Curry, Estate Planners Cheer Death of Grantor Trust Changes*, Tax Analysts Document Doc. No. 2021-41350, discussed the removal of the grantor trust changes and referred to a statement made by Howard M. Zaritsky in which he said the proposed changes were similar to taking a "meat cleaver to a problem that could better be solved with a scalpel." We agree with his description. As will be mentioned later, the staff work on preparing 2901 was unsatisfactory.

Another problem developed as to 2901 was the meaning of the effective date rule. After the draft was submitted to the Budget Committee, a change was recommended and is indicated by the following statement:

Effective Date. The provision is generally effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date. The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for sales and other dispositions after the date of enactment. (935) A technical correction may be necessary to reflect this intent. (*emphasis added*)

The additional language caused concern as to its meaning and particularly the meaning of the word "dispositions". Granting regulatory authority to provide guidance is not sufficient. The terms "sales and other dispositions" need to be defined. This should be done in the context that the title to 1062 applies to "certain sales between grantor trusts and deemed owner." This suggests that the subject matter should not cover items other than "sales" in the absence of a change in the title.

The problem is indicated by recommendations made by the AICPA in an October 1, 2021 letter to the Chairmen and Ranking Members of the House Ways and Means Committee and the Senate Finance Committee on the Budget Reconciliation Plan. See Tax Analysts Document 2021-37896 which, under a heading "**Grantor Trusts**," states:

In addition, Congress should clarify the term "contribution." The legislation indicates that they are applicable to any portion of a trust established before enactment which is attributable to a contribution to the trust made on or after such date. Clarification should include whether "contribution" includes new sales to existing grantor trusts, an exercise of an IRC section 675(4) swap power and modifications to existing intentionally defective irrevocable trust (IDIT) notes to extend maturity, or if a reduced interest rate, is construed as a "contribution." "Contributions" should not include existing sales and loans with pre-enactment grantor trusts where in-kind distributions may be required to make the loan payments as well as the use of in-kind distributions for GRAT payments for a pre-enactment GRAT. Treating such payments otherwise would be fundamentally unfair for existing transactions. For example, for a GRAT or grantor CLAT, the gift is in year one so when the assets pass to the remainder beneficiaries, it should not be a further gift or trigger transaction. Another example of our concern is existing GRATs that may need to satisfy annuity payments with in-kind distributions, such as a 2-year GRAT created in December 2019 when the final payment is made December 2021 as it is likely the final annuity payment would need to be satisfied in kind and would be subject to the higher 25% capital gains rate under the legislation.

The letter does not mention the effective date change language apparently because when it was written the AICPA was not aware of the change.

In addition to clarifying the meaning of "contribution" as suggested by the AICPA, the second sentence needs a "flushing out" of its meaning. Does it include (i) an exchange of trust assets for other assets of equivalent value, (ii) the grantor's payment of income taxes on trust income, (iii) a loan by the grantor to the trust or (iv) a post-effective date modification of a pre-existing trust? See *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991).

The Administration may come to an agreement with Senator Manchin to support a modified Build Back Better Act. This could require additional current taxes above what was projected under the Act. Given the elimination of transfer taxes in H.R. 5376, the current version of the bill, it seems unlikely that transfer tax changes would be in a revised bill.

Simple changes could be made in place of 2901 and 1062 which would address zeroed-out GRATs and sales to grantor trusts. As to GRATs, a requirement that the grantor retain a specified percentage interest in the GRAT property at termination would eliminate zeroing out. For a proposal by Senator Sanders taking this approach, see pages 13800-13801 of the January 2020 issue of Practical Drafting. As to sales to grantor trusts, a similar requirement suggested by Zaritsky – that the trust have an excess value of 20 percent over the sales price – could be imposed.

Comparing the two alternatives, the zeroed-out GRAT appears preferable because it requires only a trust document and no down-side risk as would occur with a sale to a grantor trust assuming that the grantor survives the GRAT term. Each alternative requires “grantor-trust status” to the grantor. The Administration could propose a change which terminates this status.

C. The Future

With 2021 behind us without any significant change in the transfer tax provisions (the gift tax, the estate tax and the generation-skipping transfer tax), the question becomes what might be expected in the future over the remaining three years of the Biden Administration?

A leading candidate for change would be the applicable exclusion amount which is now \$12.06 million for 2022. This change, by eliminating the increase enacted under the Trump Administration, would eliminate the increase for the years 2022-2025 and return the AEA to about one-half of the current figure.

The most important change would be to tax the unrealized appreciation in gifts, either during life or at death with exceptions for marital or charitable transfers, a special exemption for farms and other family-owned businesses and tangible personal property (other than collectibles). No fresh start for valuation purposes was includible, but a portable exemption of \$1 million was allowed. This change was proposed by the Biden Administration but was not included in versions of either the House Ways and Means Committee or the Senate Finance Committee. The failure was caused, at least in part, by objections in both the House and the Senate from farmers. The history goes back more than 50 years when carryover basis was enacted and shortly thereafter repealed.

The subject has broadened to include a periodic tax on unrealized appreciation in trusts. For example, trust property could be subject to the tax every 25 years. Senator Wyden, the Chairman of the Senate Finance Committee, is working on a proposal to do so. See Tax Notes Document Service, Docs. 2021-40764 (text) and 2021-40768 (discussion). The concept of a periodic tax was included in a draft statute prepared by Senator Van Hollen in 2021. See Issue 2021-2 at 14-16.

An important point regarding a tax on unrealized appreciation is whether the tax is constitutional. An issue here is finding an event that supports imposition of the tax. Perhaps a transfer by gift or at death would be such an event. The imposition of a periodic tax could raise a problem that would not exist with an actual transfer by gift or at death because no event concerning the ownership would have occurred.

Another question is whether the Biden Administration will propose an inheritance tax which would replace the gift tax, the estate tax and the generation-skipping transfer tax. See Batchelder, *Leveling the Playing Field Between Inherited Income and Income from Work Through an Inheritance Tax*, Tax Notes Document Service, Doc. 2020-3230. The proposal was published by the current Assistant Secretary (Tax Policy) for the Treasury and discussed in the July 2020 issue of Practical Drafting on pages 13938-13951.

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