WAYS & MEANS COMMITTEE BILL IMPROVES ESTATE & GIFT TAXES, BUT MORE REFORMS NEEDED TO REIN IN HUGE DYNASTY FORTUNES

The House Ways and Means Committee tax bill makes important improvements to estate- and gift-tax rules that would curb some of the worst abuses of the ultra-rich and provide some limits on the creation of family dynasties, but further reforms are needed. Following is an explanation of current loopholes in estate- and gift-tax law, how the Ways and Means bill addresses them, and what work remains to be done.

Rates and Exemption Levels. The top estate tax-rate is now 40% as is, nominally, the maximum gift-tax rate. However, because of how the gift tax is calculated, the effective rate is really only 28.56%. In 2021, individuals get a lifetime exclusion from estate and gift tax of $11.7 million; married couples twice that, or $23.4 million. Those figures increase each year with inflation until 2026 when they revert back to the 2017 levels of $5.5 million for individuals and $11.0 million for married couples, adjusted for inflation.

Ways and Means Bill. It accelerates to January 1, 2022 the reduction in the lifetime exclusion to 2017 levels of $5.5 million for individuals and $11.0 million for married couples, adjusted for inflation, currently scheduled to occur in 2026.

Further Legislation Needed. The bill does not address the 28.56% effective rate on taxable gifts. A provision raising the effective gift-tax rate to equal the effective estate-tax rate should be added.

The bill also leaves unchanged what is effectively a flat rate of 40% for the biggest taxable estates. Legislation now in Congress -- The For the 99.5% Act -- recognizes the vast spectrum of inherited wealth by applying a graduated rate schedule. It would levy a rate of 45% on gifts and bequests up to $10 million in excess of the lifetime exclusion; 50% between $10 million and $50 million; 55% between $50 million and $1 billion; and 65% in excess of $1 billion. These graduated rates should be incorporated into the current legislation.

Valuation Discounts. Under current law, wealthy taxpayers are able to manipulate the manner in which they hold assets to artificially lower the value of those assets for estate and gift tax purposes. They do this by transferring assets to entities like LLCs and partnerships, then distributing interests (shares) in those entities, and claiming those shares are worth less than their proportion of the underlying assets

Ways and Means Bill. It eliminates valuation discounts for nonbusiness assets.

Further Legislation Needed. The bill does not address valuation discounts on business interests. This leaves in place current law that allows family-controlled businesses to be valued for wealth transfer tax purposes at a discount of 30% or more below their actual values. The For the 99.5% Act includes provisions that eliminate the discounting of interests in family-controlled entities. Those provisions should be incorporated into the Ways and Means bill.

Intentionally Defective Grantor Trusts. An intentionally defective grantor trust (IDGT) is a trust designed to be a grantor trust for income tax purposes but to fall outside the grantor's gross estate at death, thereby dodging the estate tax. Under current law, a grantor can engineer an IDGT by (among other methods) establishing an irrevocable trust yet retaining the power to substitute assets in the trust for other property of equivalent value. IDGTs open the door to several transfer tax minimization strategies:

First, a grantor can transfer income-generating assets to an IDGT and then, entirely consistent with the grantor-trust rules, pay taxes on the IDGT's income herself. The grantor's tax payments are not considered taxable gifts. In effect, the grantor is conferring an additional benefit on the IDGT (i.e., income tax relief), but with no gift tax consequences. Second, a grantor can sell discounted assets to an IDGT in exchange for an installment note. The sale will be disregarded for income tax purposes as a transaction between the grantor and herself. Because the grantor pays the income tax on IDGT assets, any income from or appreciation of IDGT assets above the installment-note interest rate will pass to trust beneficiaries free of estate and gift tax.

Ways and Means Bill. It requires all assets held in a grantor trust to be included in the grantor's estate. This should eliminate the two tax minimization strategies discussed above.

Further Legislation Needed. Section 138209(c) of the Ways and Means bill, the provision governing the application of new Code Section 1062 to existing grantor trusts must be clarified. Section 138209(c) limits the application of new Code section 1062 to IDGTs formed on or after the date of enactment and the part of a pre-existing IDGT "attributable to a contribution" made on or after the date of enactment. That could allow an IDGT formed prior to the date of enactment to make additional sales of assets to the IDGT. The section should be amended to apply new Code Section 1062 to the part of a pre-existing IDGT "attributable to a transfer to the trust, either by contribution, sale, or exchange" after the date of enactment.

Further, bill section 138209(c) should address the payment by the grantor of income tax on income of an IDGT that was formed prior to the date of enactment. The payment on or after the date of enactment by a grantor of income tax on the income of an IDGT attributable to any period ending on or after the date of enactment should be treated as a contribution by the grantor to the IDGT for purposes of the effective date rules of bill section 138209(c).

Grantor Retained Annuity Trusts. When a grantor makes a transfer to a trust, section 2702 of the tax code allows the grantor to calculate the taxable gift amount by subtracting the value of any "qualified interest." Under section 2702(b)(1), "qualified interest" includes a term annuity retained by the grantor. The value of the retained annuity is calculated using the section 7520

rate (i.e., 120% of the federal midterm rate). These provisions have given rise to a highly effective transfer-tax minimization strategy, known as a zeroed-out GRAT, where the grantor retains an annuity with a value equal or nearly equal to the value of the GRAT's assets. If the assets in the zeroed-out GRAT grow faster than the Treasury-based rate, the GRAT will have money left over after it's done paying out the annuity, and that money will go to the GRAT's beneficiary free of any gift tax. If GRAT assets grow slower than the Treasury rate or dip in value, the trust will run out of money before it makes all of its annuity payments. The trust will cease to exist, and no one will owe any tax. From the grantor's perspective, this is a heads-I-win, tails-we-tie bet with the IRS.

Ways and Means Bill. It does not address GRATs directly. The provisions in the bill directed at intentionally defective grantor trusts likely will curtail the use of zeroed-out GRATs but some use of zeroed-out GRATs may continue.

Further Legislation Needed. The For the 99.5% Act includes a GRAT reform proposal with two elements: (1) a minimum 10-year term for all new GRATs, and (2) a requirement that the remainder interest at the outset of a GRAT be at least equal to $500,000 or 25% of contributed assets (whichever is greater). That proposal should be incorporated into the current legislation.

Dynasty Trusts and the Leveraging of the Generation-Skipping Tax Exemption. Current law allows for the creation and growth of trusts which, once funded, are shielded from estate, gift and generation-skipping tax for an unlimited number of generations. These trusts are known as dynasty trusts.

Assets held in a multi-generational trust generally are not subject to estate or gift tax upon the passage of all the members of a generation. The mechanism by which the tax code is meant to prevent permanent avoidance of estate and gift tax through the use of multi-generational trust is the generation-skipping tax, or GST.

The GST works by imposing an additional layer of tax on wealth transfers that skip a generation, for example, from grandparent to grandchild. In the case of a trust providing for multiple generations of an ultra-rich person's descendants, the additional layer of tax would occur as each generation of descendants passed on and the next generation became the primary beneficiaries of the trust, or upon any distribution to a more remote descendant of the trust creator than the beneficiaries then nearest in generation to the trust creator.

There are three major flaws in the GST, all involving the exemption that each person is allowed from GST taxation. The first is that the GST exemption, in 2021 $11.7 million per person, is too large. If an ultra-rich grandparent applies her GST exemption to an $11.7 million gift to her young, also ultra-rich grandchild who won't need to touch the wealth, the gift easily could grow to $500 million during the grandchild's lifetime.

The second and even bigger flaw in the GST exemption is that it can be applied to a trust that will last for multiple generations. These trusts, known as "dynasty trusts," are designed to exist

for multiple generations of a person's descendants. The laws of some states allow dynasty trusts to last in perpetuity.

When the GST exemption is used in tandem with other tax avoidance vehicles, the amount wealthy Americans are able to lodge in dynasty trusts is far greater than the current $11.7 million statutory exemption. Massive fortunes, sometimes exceeding one billion dollars, can be placed in dynasty trusts that will remain exempt from wealth transfer taxation for centuries.

The third major flaw in the GST is that Congress in 1986 granted a perpetual exemption from the GST for trusts that had become irrevocable by September 25, 1985 (the date on which the reformed GST legislation was introduced). Assets transferred to grandfathered trusts before then can continue to grow and be distributed to beneficiaries free of estate, gift, or GST.

Dynasty trusts present two challenges: curtailing the creation of new dynasty trusts and addressing the dynasty trusts that already exist and that hold massive accumulations of wealth.

Ways and Means Bill. It would partially address the creation and growth of new dynasty trusts in two ways. First, as noted above, it would accelerate to 2022 a reduction in the GST exemption amount to $5 million ($10 million per couple) currently scheduled for 2026. Second, it would curb the use of strategies such as IDGTs, GRATs, and valuation discounts that exploit the GST exemption to shield vast fortunes.

Further Legislation Needed. The Ways and Means bill would not limit the GST-exempt status of dynasty trusts. Even modest amounts of wealth lodged in new dynasty trusts could accumulate to massive fortunes if sheltered from wealth transfer tax for a century or more. The bill also does not address existing dynasty trusts. In all likelihood, trillions of dollars of wealth already are stashed in dynasty trusts, which could continue to grow for centuries, even in perpetuity, entirely free of wealth transfer tax. Just one South Dakota trust company boasts of having over 100 billionaire and 300 centimillionaire clients, with over $100 billion in trust assets under administration.

Law professor Daniel Hemel and Robert Lord of Americans for Tax Fairness have a three-part proposal to limit the application of the GST exemption to trusts:

- The GST exemption should be reduced to $3.5 million.
- Measures included in the Ways and Means bill and the measures discussed in this memorandum to close the valuation discount, IDGT and GRAT loopholes should be enacted.
- The GST exemption should be limited to transfers to persons who either are living at the time of the transfer or are within two generations of the transferor.

For purposes of this proposal existing trusts would be treated as if they were established on the effective date of the legislation. Thus, the GST exemption of an existing trust would apply to distributions to any beneficiary of the trust who either is alive on the effective date of the legislation or is within two generations of the grantor of the trust. Upon the death of all qualified beneficiaries of a GST-exempt trust, the trust would become subject to the GST.