The "Mis" STEP Act–What it Means To Your Estate and Income Tax Plan

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Overview

In late March, a group of five Democrat Senators from northeastern states introduced the "Sensible Taxation and Equity Promotion (STEP) Act. Similar legislation has been introduced into the U.S. House, also from an East Coast Democrat. These bills, combined with S.994 that I wrote about last time, would make vast changes to the federal estate and gift tax system, have a monumental impact on estate planning for many – including farm and ranch families – and would also make significant income tax changes. The STEP Act also has a retroactive effective date of January 1, 2021. That makes planning to avoid the impacts next to impossible. Today's focus will be on the provisions of the STEP Act.

The key components of the STEP Act and its impacts and planning implications – it's the topic of today's post.

Income Tax Provisions

Before addressing the STEP Act's provisions, it's important to remember other proposals that are on the table. Those include an income tax rate increase on taxable income exceeding $400,000 (actually about $450,000) by setting the rate at 39.6 percent. Also, for these taxpayers, the itemized deduction tax benefit is capped at 28 percent. That makes deductions less valuable. In addition, the PEASE limitation of three percent would be restored. This limitation reduces itemized deductions by three percent of adjusted gross income (AGI) over a threshold, up to 80 percent of itemized deductions. Also, proposed is a phase-out of the qualified business income deduction (QBID) of I.R.C. §199A. The phaseout of the QBID would impact many taxpayers with AGI less than $400,000.

Capital Gains

The STEP Act is largely concerned with capital gains and trusts. The STEP Act applies the 39.6 percent rate to capital gains exceeding $1,000,000. Passive gains exceeding this threshold would be taxed at 43.4 percent after adding in the additional 3.8 percent net investment income tax of I.R.C. §1411 created by Obamacare. An additional $500,000 exclusion is provided for the transfer of a personal residence ($250,000 for a taxpayer with single filing status). Also, outright charitable donations of appreciated property are excluded, but (apparently) not transfers to charitable trusts), and some assets held in retirement accounts.

From an estate planning standpoint, if this provision were to become law a "lock-in" effect would occur to some extent – taxpayers would simply hold assets until death to receive the basis adjustment at death equal to the asset's fair market value (I.R.C. §1014). Unless, of course, the "stepped-up" basis rule is eliminated.

Note: Planning strategies such as charitable remainder trusts (maybe), appropriate timing of the harvesting of gains and losses and similar techniques can be used to keep income under the $1 million threshold. Also, especially for high-income taxpayers residing in states with relatively high income tax rates, a tax minimization strategy has been the use of the incomplete non-grantor trust (ING). An ING is a self-settled, asset protection trust that allows a grantor to fund the trust without incurring gift tax while also achieving non-grantor status for income tax purposes. The typical structures is to establish the trust is a state without an income tax with the grantor funding the ING with appreciated assets having a low basis. The ultimate sale of the trust assets thereby avoids state income tax. The IRS has announced that it is studying INGs and will not issue any further rulings concerning them. *Rev. Proc. 2021-3, 2021-1, IRB 140, Sec. 5.*

Trusts

The Step Act also proposes new I.R.C. §1261 which, under certain circumstances, imposes income recognition on gains at the time an asset is transferred to a trust. Under this provision, gain recognition occurs at the time of a transfer to a non-grantor trust, as well as a grantor trust if the trust assets (corpus) will not be included in the grantor's estate. If the corpus will be included in the grantor's estate at death, there apparently is no gain until a triggering event occurs. *Proposed I.R.C. §1261(b)(1)(A).*

Note: The lack of clarity of the STEP Act's language concerning transfers to grantor trusts creates confusion. Seemingly the relinquishment of all retained powers under I.R.C. §2036 would mean that the trust corpus would not be included in the grantor's estate, and the transfer to trust would be an income recognition event. It simply is not clear what the STEP Act's language, "would not be included" means.

Apparently, a transfer to a non-grantor marital trust is not an income recognition event. *Proposed I.R.C. §1261(c)(2).* Similarly, a transfer qualified disability trust or cemetery trust does not trigger gain recognition. As noted above, the language is unclear whether a transfer in trust to a charity is excluded from recognition. However, a transfer to a natural person that is other than the transferor's spouse is taxed at the time of the transfer.

Assets that are held in a non-grantor trust would be deemed to be sold every 21 years. That will trigger gain to the extent of unrealized appreciation every 21 years, with the first of these "trigger dates" occurring in 2026.

The STEP Act also requires annual reporting for trusts with more than $1 million of corpus or more than $20,000 of gross income. The reporting requires providing the IRS with a balance sheet and an income statement, and a listing of the trustee(s), grantor(s) and beneficiaries of the trust.

Note: The built-in gain on an asset that is transferred during life either outright to a non-spouse or to a type of trust indicated above cannot be spread over 15 years. However, the transfer of illiquid property (e.g., farmland) to a non-grantor trust that is not otherwise excluded is eligible for installment payments over 15 years, with interest only needing to be paid during the first five years. If the tax on the appreciated value is caused by death, the tax can be paid over 15 years by virtue of I.R.C. §6166.

Grantor trusts – sales and swaps. An important estate planning technique for higher wealth individuals in recent years designed to reduce potential estate tax involves the sale or gifting of assets to a grantor trust. The goal of such a transaction is to make a completed transfer for federal estate and gift tax purposes, but retain enough powers so that the transfer is incomplete for income tax purposes. This is the "intentionally defective grantor trust" (IDGT) technique. The result of structuring the transaction in this manner is that the future appreciation of the assets that are sold to the trust is removed from the grantor's estate, and the grantor remains obligated for the annual income tax liability. Of course, the trust could reimburse the grantor for that tax obligation. Thus, the grantor ends up with a tax-free "gift" to the trustee of the trust's income tax liability. This allows the trust assets to grow without loss of value to pay taxes.

The IRS blessed the IDGT technique in Rev. Rul. 85-13, 1985-1 C.B. 184. In the Ruling, the IRs determined that the grantor's sale of the asset to the trust did not trigger income tax – the grantor was simply "selling" to himself. The irrevocable, completed nature of the transfer to the trust coupled with grantor trust status for income tax purposes is done by particular trust drafting language. Also, that language can be drafted to allow the grantor to "swap" low basis assets in the trust with assets having a higher basis. This allows the "swapped-out" asset to receive a basis increase at the time of the grantor's death by virtue of inclusion in the grantor's estate. I.R.C. §1014.

Under the STEP Act, a sale to a grantor trust might be treated as a transfer in trust. If that is what the language means, then Rev. Rul. 85-13 is effectively repealed. It also appears that swaps to a grantor trust would be treated that same as a sale. If this is correct, IDGTs as a planning tool are eliminated.

GRATs. One popular estate planning technique for the higher-valued estates has been the use of a grantor-retained annuity trust (GRAT). With this approach, the grantor transfers assets to a trust in return for an annuity. As the trust assets grow in value, any value above the specified annuity amount benefits the grantor's heir(s) without being subject to federal gift tax. However, under the STEP Act, a transfer to a grantor trust is taxable if all of the transferred assets are *not* included in the grantor's estate. But, if *all* of the assets transferred to a grantor trust are included in the grantor's estate, the transfer to the trust is not a taxable event.

This language raises a couple of questions. One of the characteristics of a GRAT is that it can be drafted to make a portion taxable. In that case, it is not completely includible in a decedent's estate. Likewise, if property is transferred into a GRAT and the transferor dies during the GRAT's term and the I.R.C. §7520 rate rises, then less than all of the corpus of the GRAT is included in the decedent's estate. *See Treas. Reg. §20.2036-1, et seq.* This would appear to mean that, under the STEP Act, the transfer to the GRAT would be a taxable event. It is also unclear whether the use of a disclaimer in the context of a GRAT will eliminate this potential problem.

Estate Tax Deduction

Income taxes that the STEP Act triggers would be deductible at death as an offset against any estate tax that is due on account of the taxpayer's death.

The Constitutional Issue

As noted above, the STEP Act carries a general effective date of January 1, 2021. It is retroactive. If that retroactive provision were to hold, many (if not all) planning options that could presently be utilized will be foreclosed. But is a retroactive tax provision constitutional?

To be legal, a retroactive tax law change can satisfy the constitutional due process requirement if it is rationally related to a legitimate purpose of government. Given the enormous amount of spending that the Congress engaged in during 2020 to deal with the economic chaos caused by various state governors shuttering businesses, a "legitimate purpose" could be couched in terms of the "need" to raise revenue. *See, e.g., Pension Benefit Guaranty Corporation v. R.A. Gray & Co., 467 U.S. 717 (1984); United States v. Carlton, 512 U.S. 26 (1994); In re Fifield, No. 04-10867, 2005 Bankr. LEXIS 1210 (Bankr. D. Vt. Jun. 20, 2005).* That's the case even though historic data indicate that government revenues rarely increase in the long-term from tax increases – particularly the type of tax increases that are presently being proposed.

Planning Steps

Will the STEP Act become law as proposed? Probably not. But, combined with S. 994 the two proposals offer dramatic changes to the rules surrounding income tax, as well as federal estate and gift tax. With the proposal to basically double the capital gains tax rate, it could be a good idea to intentionally trigger what would be a gain under the STEP Act. Doing so would at least remove those assets from the transferor's estate. In general, "harvesting" gains now before a 39.6 percent rate applies could be a good strategy. Also, estate plans should be reexamined in light of the possible removal of the fair market value basis rule at death. Consideration should be given to donating capital gain property to charity, setting up installment sales of property, utilizing the present like-kind exchange rules and making investments in qualified opportunity zones.

Is all planning basically eliminated for 2021? I don't know. There simply is no assurance whether transfers made to lock in the existing federal estate and gift tax exemption, utilize valuation discounts, etc., will work. If the STEP Act is enacted, perhaps one strategy that will work would be to gift cash (by borrowing if necessary). If the STEP Act is not enacted, then utilizing grantor trusts with sales and swaps could be an effective technique to deal with a much lower exemption.

One key to estate planning is to have flexibility. The use of disclaimer language in wills and trusts is one way to provide flexibility. Coupled with a rescission provision, disclaimer language included in documents governing transactions completed in 2021 might work…or might not. It's also possible that such a strategy could work for estate and gift tax purposes, but not for income tax purposes.

Another technique might be to set up an installment sale of assets to a marital trust for the spouse's benefit that gives the spouse a power of appointment and entitles the spouse to lifetime income from the entire interest payable at least annually (basically a QTIP trust for the spouse (see I.R.C. §2523(e)). The STEP Act indicates that such a transfer would not be a gain recognition event – marital trusts are excluded so long as the spouse is a U.S. citizen. The surviving spouse would be given the power to appoint the entire interest and it could be exercised in favor of the surviving spouse or the estate of the surviving spouse. No person other than the surviving spouse could have any power to appoint any part of the interest to any person other than the surviving spouse. With a disclaimer provision the surviving spouse could disclaim all interest in the trust if the STEP Act is not enacted (or is enacted but becomes effective after the transfer by installment sale). The disclaimer would then shift the assets into a trust for the surviving spouse's heirs. There are other techniques that could be combined with this approach to then add back the spouse. If the STEP Act is enacted, the assets could remain in the marital trust and not trigger gain recognition. The point is that the disclaimer adds tremendous flexibility (until disclaimers are eliminated – but the drafters of the STEP Act haven't figured that out yet).

Also, I haven't even discussed the proposed American Families Plan yet. On that one, Secretary Vilsack's USDA put out an incredibly misleading press release titled, "The American Families Plan Honors America's Family Farms." In it, the USDA claims that the proposed changes to the federal estate tax would apply to only two percent of farms and ranches. That's true as long as the family continues to own the farm *and* is materially participating in the farming operation. What the USDA didn't mention is that the American

Families Plan eliminates many income tax deductions and will increase the federal income tax bill for practically all farmers and ranchers.

Conclusion

Presently, there is considerable uncertainty in the income tax and estate/business planning environment. Also, the next shift in the political winds could wipe-out all of these proposed changes (if enacted) and the rules will swing back the other direction.

There's never a dull moment. I can't emphasize enough how important it is to attend (either in-person or online) this summer's national conference on farm income tax and estate/business planning. It's imperative to get on top of these issues. For more information on those conferences click here: https://www.washburnlaw.edu/employers/cle/farmandranchtaxjune.html and here: https://www.washburnlaw.edu/employers/cle/farmandranchtaxaugust.html