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Planning for High Net Worth Individuals: Proposed Tax Changes and What to Do About Them

Congress is currently debating a budget reconciliation bill that, if enacted, will make significant changes to the tax code. Among the most important changes for high net worth individuals are (1) a reduction of the gift, estate and generation-skipping transfer ("GST") tax exemptions from the current level of $11.7 million per person ($23.4 million for married couples) down to $6.02 million per person ($12.04 million for married couples), (2) increases in income tax rates (including on capital gains) for high income individuals and trusts, (3) sweeping changes to the treatment of grantor trusts, including GRATs and insurance trusts, and (4) new rules that would eliminate "back-door" Roth IRA conversions and require mandatory distributions if a taxpayer's aggregate IRAs are worth more than $10 million.

None of these changes is yet law, and we will continue to monitor Congress's actions as they debate the proposals. **We hope you'll join us on November 2nd for a webinar event to review the current state of the proposed legislation, and discuss its impact on the markets.**

In the meantime, there are several steps clients can take to plan for the most likely tax code changes.

1. Lifetime exemption – "use it by December 31st or you may lose it"

If enacted, the draft legislation would reduce the gift, estate and GST tax exemptions to $6.02 million per person, starting on January 1st, 2022. This means that clients would have until December 31st to take advantage of the current large exemption amounts before the opportunity would be lost.

To plan for this likely change, clients should consider making large gifts now that fully use their present exemption amounts. By making gifts now, you will pass to your family not only the present value of the gifted assets, but also their future growth, entirely gift-tax-free. Further, the gifted assets and the future appreciation will be out of your own taxable estate, potentially saving significant estate taxes in the future. We recommend making decisions about using your exemptions sooner rather than later, to allow plenty of time to accomplish gifts well before December 31st.

This recommendation is most relevant for clients who can give away more than $6.02 million. If you intend to give less, then you have more time to plan, as the $6.02 million per-person exemption amount should still be available in 2022 and future years under the proposed bill.

2. Income and capital gains tax increases

Under current law, top income earners pay a 37% federal income tax on ordinary income. The proposed legislation would increase the top individual tax rate to 39.6% (returning to the top rate in effect in 2017). The proposed legislation would also lower the income threshold at which the top rate applies to $425,000 for heads of households and $450,000 for married individuals filing jointly, starting in 2022. The present "Medicare surtax" on net investment income of 3.8% will continue to apply, as it does now, increasing the total top rate to 43.4%.

The proposed bill would also impose an additional 3% tax, starting in 2022, on individuals, trusts (other than certain charitable trusts) and estates with modified adjusted gross income over a certain threshold. For single individuals, heads of households, joint returns and surviving spouses the threshold would be $5 million. For married individuals filing separately the threshold would be $2.5 million. For estates and trusts, the 3% surcharge would apply to modified adjusted gross income over $100,000.

Finally, the bill also proposes a top capital gains tax rate of 25% (up from the current rate of 20%) for long term capital gains realized by high income individuals, using the same thresholds as apply for the top ordinary income tax rate. Again, the 3.8% "Medicare surtax" will continue to apply as it does now, increasing the top capital gains tax rate to 28.8%.

Somewhat surprisingly, the new 25% capital gains tax rate would be effective for any gains realized after September 13, 2021, which was the date the House bill was introduced. This means that individual taxpayers cannot accelerate sales now to lock in the lower 20% rate, since the new 25% rate may be deemed to have taken effect already.

3. Elimination of grantor trust benefits

Under current law, many estate planning techniques involve the use of "grantor trusts." A grantor trust is a special type of trust (there are many varieties) whereby the donor continues to pay the income tax liability on the trust assets – allowing the trust assets to grow income-tax-free for the beneficiaries – and yet the trust assets are not includible in the grantor's taxable estate. Common examples of grantor trusts include trusts that own life insurance, grantor retained annuity trusts ("GRATs"), and trusts that benefit the donor's spouse.

Among other changes, the proposed legislation would (a) effectively eliminate the use of new grantor trusts, (b) penalize a donor for adding assets to pre-existing grantor trusts (including insurance trusts), and (c) treat transfers between the donor and his or her grantor trust (possibly including GRAT annuity payments) as realization events for capital gains tax purposes. The likelihood and applicable date of these changes remain uncertain.

There are, however, steps you can take now to plan for these changes in case they become law. For example, you should be able to pre-fund an insurance trust now with the premiums needed to pay for the policy into the future, without adverse consequences. This could be important if the legislation makes contributions post-enactment inadvisable. Further, implementing asset substitutions with existing grantor trusts (including GRATs) might be worth considering now, in case income-tax-free substitutions are no longer possible after enactment.

4. Retirement account changes

The proposed legislation would make significant changes to the rules governing retirement accounts. If enacted, individuals in the top income tax bracket would no longer be able to make any (Roth or traditional) IRA contributions if their aggregate retirement account values exceed $10 million. Further, in each year that your aggregate retirement account balance exceeds $10 million, you would be required to take a mandatory minimum distribution equal to 50% of the excess value over $10 million, and 100% of the excess value over $20 million.

The proposed legislation would also restrict IRAs from holding certain types of private securities, such as those available only to high net worth "accredited investors" or "qualified purchasers." This change is intended to address a perceived ability by the wealthy to use tax-favored IRAs to subsidize their specialized investing. For IRAs that currently own private securities, the legislation would provide a two-year grace period to divest without penalty.

The proposed legislation may also eliminate so-called "back-door" Roth IRA conversions, preventing top income earners from converting funds in a traditional IRA or employer-sponsored plan into a Roth IRA, and prohibiting all individuals, regardless of income, from making any after-tax contributions to employer-sponsored plans or converting those after-tax funds into Roth IRAs. Each of these changes could take effect as early as January 1st, 2022.

5. Loss of valuation discounts for passive non-business assets

Under current law, passive non-business assets held in family LLCs and similar vehicles may qualify for valuation discounts when transferred by a taxpayer to his or her heirs via will or trust.

The proposed legislation would eliminate valuation discounts on these sorts of assets when not used in the active conduct of a trade or business. This change would take effect upon enactment. As such, if you anticipate making such a transfer, we recommend acting soon, before the proposed legislation becomes law.

6. Bottom line: Uncertainty remains, act now to use your exemptions

Again, it's difficult to know which of these many proposals will make it into the final legislation. Of all the possible changes, a reduction in the per-person gift, estate and GST exemptions to $6.02 million appears most likely to pass. Therefore, if you are considering large gifts, we recommend acting now (long before December 31st) to use those exemptions before they are lost.

We will continue to monitor Congress's actions on the proposed legislation, and we invite you to reach out to any member of your Choate team for guidance.

Note: You may have received advice in the past from a lawyer (at Choate or elsewhere) about your estate planning. That lawyer was working with you at a particular moment in time, based on the laws then in effect. The advice that you received in the past may no longer be optimal, especially as laws change. Accordingly, you may find it beneficial to consult with a lawyer who can review your planning in light of the current situation.

If you have questions regarding these developments, please contact a member of the Family Office Services team.

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