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WASHINGTON WATCH

2024 PROPOSED BUDGET

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Earlier last month, the Biden Administration released its 2024 proposed budget, which outlines its priorities for the next fiscal year. Consider this a 'wish list' of the administration's top priorities, but also remember it is unlikely that many of these proposals will be enacted into law given the realities of a divided Congress. However, as we approach a presidential election year, we expect many of the issues—especially those around taxes—will become focal points of the campaign.

Below, we have highlighted several of the key provisions around financial, trust, and estate planning for ultra-high-net-worth (UHNW) families:

The Billionaire Minimum Income Tax

The proposed budget suggests a minimum tax on UHNW individuals whose net worth for the taxable year exceeds $100 million in net assets. A minimum tax rate of 25 percent would be applied to the sum of a taxpayer's taxable income plus net unrealized gains for the taxable year, serving as a "pay as you go" approach for the wealthy. Today, people who derive income from their investment assets, such as corporate stock, can avoid paying tax on gains unless and/or until they sell the assets. And, if they don't sell or gift the assets during their lifetime, the assets passed onto beneficiaries will receive a step-up in basis equal to the fair market value of the asset at the time of inheritance. Step-up in basis at death can be a huge income-tax savings because the basis of an asset is subtracted from the sale price when calculating the amount owed in tax. Under current rules, any tax on unrealized gains accrued during the decedent's lifetime never gets paid when the assets transfer to beneficiaries, even if later sold. The proposed budget also ends step-up in basis at death. The proposed Billionaire Minimum Income Tax applies to two entirely new tax bases – wealth and unrealized capital gains - and would be a third additional income tax, adding to the existing alternative-minimum tax.

Individual Tax Rate

The current top marginal income tax rate of 37 percent applies to income earned above $578,125 for single filers ($693,750 if married filing joint). The top marginal income tax rate would increase from 37 percent to 39.6 percent for single filers earning more than $400,000 ($450,000 if married filing joint) per year.

Capital Gains Tax Rate

The proposed budget recommends taxing capital gains at a new top marginal income tax rate of 39.6 percent (plus a 5 percent Net Investment Income Tax (NIIT)) for taxpayers whose income exceeds $1 million. For these taxpayers, today, long-term capital gains and dividends are taxed at a top rate of 20 percent, plus the 3.8 percent NIIT. The lower tax rate on investment income (lower than income taxes on wages) reflects the investment's principal has already incurred wage taxes when it was earned, and in the case of business profits, these profits were already taxed by the business at the corporate tax rate. Thus, this change would result in a "doubling down" on taxes.

Corporate Tax Rate

The corporate income-tax rate would increase from 21 percent on all taxable income to 28 percent. While the proposed rate is higher than the current income tax rate of 21 percent, the rate is still not close to the maximum income tax rate of 35 percent from 1993 to 2017.

NIIT and Medicare Tax

NIIT applies to individuals who fall above certain income thresholds -- specifically, single filers with income of more than $200,000 ($250,000 if married filing jointly). For those who exceed the income threshold amount, the NIIT is imposed on the amount of their net investment income or the amount by which their modified adjusted gross income (AGI) exceeds their income threshold of $200,000 (or $250,000 if married filing joint), whichever is lower. Under the proposed budget, the NIIT rate would increase from 3.8 percent to 5 percent once income exceeds $400,000. For these same taxpayers, a 0.9 percent Medicare surtax is imposed using the same thresholds. Additionally under the proposed budget, the Medicare surtax is increased from 0.9 percent to 2.1 percent once income exceeds $400,000.

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End Step-Up in Basis

Under the proposed budget, gratuitous transfers made during life or at death would become recognition events for income-tax purposes as it relates to unrealized gains, which would create tax liability in addition to other possible transfer taxes such as gift or estate taxes. If the proposal follows the 2023 budget, the change applies to unrealized capital gains over $5 million for single filers ($10 million for married couples) – the exemption amount. An individual's $5 million exemption would be portable to a surviving spouse if not fully used by the first spouse to die, which gets added to the surviving spouse's unused individual exemption amount.

Grantor Trusts

Under the Internal Revenue Code (IRC) rules, an individual who creates a trust (the grantor) may be treated as the owner of all or part of the trust. As such, the grantor is responsible for the tax liabilities attributable to the trust's earnings. Any tax on interest received on a note or capital gains that relate to sales or other transactions between the grantor and the grantor trust are ignored because the grantor and the grantor trust are deemed to be the same taxpayer. All revocable trusts are grantor trusts; however, irrevocable trusts may or may not qualify as grantor trusts unless certain conditions are met. If an irrevocable grantor trust is properly structured, the grantor can remove significant assets from the grantor's gross estate that may otherwise be subject to income and/or transfer taxes (e.g., taxes such as gift or estate tax).

- **Income Tax Payments Treated as Gifts:** The proposed budget disincentivizes the use of irrevocable grantor trusts by requiring income-tax payments made by the grantor to be treated as taxable gifts to the trust. The gift amount would be the sum of all income taxes paid less any reimbursements made to the grantor by the trust. The gift cannot be reduced by the marital deduction, charitable deduction, or various gift exclusions under IRC.
- **Capital Gain Recognition for Sale Transactions:** The proposed budget provides that in the case of a sale of appreciated assets to an irrevocable grantor trust in exchange for an installment note payable to the grantor (or any other person who is regarded for income tax purposes), such sales would be considered a recognition event triggering capital gain (losses would be disallowed). Additionally, the basis in the hands of the trust (the buyer) would be equal to the value of the asset at the time of transfer. Today, a sale would not trigger a capital gain, and the basis remains the same as the grantor's basis because the sale is a disregarded transaction.

The proposals do not apply to revocable trusts or securitization transactions.

Grantor Retained Annuity Trust (GRAT) and Charitable Lead Annuity Trust (CLAT)

A GRAT is a trust used to minimize taxes on large financial gifts, usually to family members, as well as to "freeze" the estate value of the grantor by shifting the future appreciation of GRAT assets to remainder beneficiaries at the end of the GRAT term. Shifting future appreciation helps to reduce the grantor's overall taxable estate. During the term of a GRAT, the grantor retains an annuity which is calculated at the time of funding using the Internal Revenue Service (IRS) §7520 rate. Typically, GRATs are structured such that the annuity payments equal the amount used to fund the GRAT, resulting in what is commonly referred to as a "zeroed-out GRAT" for gift tax purposes. Thus, the grantor does not have to pay any gift tax nor use any gift exemption. To the extent the GRAT assets appreciate and outperform the IRS §7520 rate, the excess value will pass to remainder beneficiaries either outright or in further trust at the end of the GRAT term. Most GRATs are for a term of 2-10 years. A term of two-years is deemed a short-term GRAT. These are popular because they provide relief in a couple of ways. First, if the grantor dies during the GRAT term, the assets can be included in the grantor's estate for purposes of calculating the estate tax; a short-term GRAT makes the likelihood of successfully transferring wealth more probable. Second, a short-term GRAT may help maximize returns due to shorter investment periods, as well as provide the grantor access to liquidity sooner (e.g., 50 percent annuity payout each year). The proposed budget would eliminate short-term GRATs and require: (i.) a term of at least 10 years (and no longer than the life expectancy of the grantor plus 10 years, and (ii.) the calculated remainder interest for gift tax purposes be 25 percent of the value of assets contributed or $500,000, whichever is greater.

GRATs and CLATs work similarly. With a CLAT, however, the annuity is paid to a charity for a term of years instead of the grantor. At the end of the CLAT term, any excess value will pass to non-charitable beneficiaries, usually to family members, or back to the grantor. Using the same approach as a GRAT, you can structure a "zeroed-out CLAT" for gift tax purposes to non-charitable beneficiaries. Additionally, the CLAT allows the grantor a charitable deduction (up to 30 percent of AGI depending on the type of assets contributed) for the present value of the annuity stream paid to charity. Both GRATs and CLATs can implement graduated annuity payments year-over-year thereby allowing assets to remain in the trust longer and appreciate for remainder beneficiaries. Unlike a GRAT, though, there is no limit regarding the percentage increase year-over-year for a CLAT; a GRAT is limited to a 20 percent increase each year. The proposed budget suggests the calculated noncharitable remainder interest for gift tax purposes be at least 10 percent of the value of assets contributed to the CLAT, and annuity payments to charity would need to be a level, fixed amount over the term of the CLAT.

Annual Exclusion Gifts

Under current law, individuals may exclude from gift tax up to $17,000 annually per donor/recipient in transfers of present interest; meaning, the recipient has immediate use and enjoyment of the property. When a trust benefits multiple beneficiaries, let's assume five, who have a present interest, that means the donor can transfer $17,000 multiplied five ($85,000) gift-tax free (other rules apply for the trust to qualify for the annual exclusion). Under the proposed budget, the present interest requirement goes away for trusts and a new "category" of transfers is created and allocated an annual limit of $50,000 per donor, indexed for inflation after 2024. The category of transfers would include the following transfer types: transfers in trust (exception applies for certain direct transfers in trust to a skip person), transfers of interests in pass-through entities such as LLCs, transfers of interests subject to a prohibition on sale, partial interests in property, and other transfers of property that that cannot be immediately liquidated by the recipient (without regard to the existence of any withdrawal, put, or other such rights). The proposal would be put into place effective 12/31/23, and to the extent a donor's transfers fall within the new category and exceed $50,000 in a single year, the excess would be considered a taxable gift. Going back to the example of funding a trust with five beneficiaries, under the proposed budget, the donor would only be allowed a $50,000 gift-tax annual exclusion, and the balance of $35,000 would be a taxable gift ($85,000-$50,000=$35,000).

Trust Loans

Loans are often used as an estate-planning technique, especially in a low interest-rate environment. The proposed budget highlights loans from trusts as a way of avoiding: (i.) generation-skipping transfer tax (GSTT), and (ii.) tax on trust income because assets leave the trust. GSTT comes into play when a gift, or trust distribution from a non-exempt GST trust, is made to a "skip person". The GSTT is separate from, and in addition to, the gift and estate tax. A "skip person" is a person who is two or more generations younger than the person who transfers assets (the transferor), such as a grandchild, or any person who is at least 37 ½ years younger than the transferor

When a loan is made to a skip person from a non-GST exempt trust, the GSTT is avoided unless and until the loan is forgiven. When a loan is forgiven or not otherwise repaid; technically, the loan is a gift. Depending on the amount of the gift, a gift tax and/or GSTT may be assessed. Whether the assessed tax must be paid will depend on whether the transferor has any remaining gift/GSTT exemption (currently $12.92 million per individual but subject to change after 2025 to $5 million, indexed for inflation). Gifts should be reported to the IRS on a gift tax return (Form 709). The perceived loss of trust income tax revenue by the IRS relating to outstanding loans to beneficiaries of trusts has resulted in the proposal to treat loans to, and use of trust assets by, a trust beneficiary as a distribution for income tax purposes. Moreover, if that beneficiary is a skip person, GSTT would be imposed if the proposed budget also highlights loans to a grantor of a grantor or trust, specifically as it relates to GSTT. Today, transactions between the grantor and the grantor trust (explained above) are disregarded for income-tax purposes. Additionally, any loan interest the grantor pays to the trust does not qualify for an interest deduction nor is the interest payment or principal re-payment treated as a gift to the trust beneficiaries. Under the proposed budget, however, when a loan is made to a grantor (or spouse) and repaid, the repayment amount would be considered a new contribution to the trust for purposes of GSTT, assuming skip persons are named beneficiaries of the trust individuals have a gift/GSTT exemption available but once exhausted, any gift and/or GSTT assessed must be paid. Who pays the GSTT and when depends. When the grantor makes a direct transfer to skip a person, the grantor pays the GSTT upon transfer. But when the grantor makes an indirect transfer, the skip person pays the GSTT when a trust distribution is made to a skip person, or the trust terminates and distributes to skip persons. An indirect skip means the skip person does not have immediate use and enjoyment over the assets until certain conditions are met.

Duration Limit of Generation-Skipping Transfer Tax (GSTT) Exemption

GSTT comes into play when a gift or trust distribution from a non-exempt GST trust is made to skip persons. An individual's GSTT exemption may be allocated to transfers made to skip persons, whether the gift is made outright or in trust. When assets are transferred to a trust and GSTT exemption is applied, it is possible to shield assets from transfer taxes (i.e., gift tax, estate tax, GSTT tax) for centuries, or even indefinitely in some states, if the assets never leave the trust. However, once assets are distributed, the assets now belong to the recipient beneficiary(ies) and the generations are reset for transfer tax purposes. Limiting these "perpetual" trusts to a period of years has been discussed for years. Under the proposed budget, which would apply to pre- and post-enactment trusts, the GSTT exemption could only be used to avoid GSTT for:

1. Direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generations who were alive at the trust's creation, and
2. Taxable terminations occurring while any person described in (1) is a beneficiary of the trust.

The result is the GSTT exemption would not last for the duration of the trust; rather, the GSTT exemption would only protect trust assets for the life of a beneficiary who is no younger than the transferor's grandchild or is a member of a younger generation who was alive when the trust was created. After that, the trust is no longer a GST-exempt trust. In addition, the proposal limits techniques to mitigate or defer GSTT liability. If a GST-exempt trust purchases property that is subject to GSTT, a redetermination of the purchasing trust's inclusion ratio would be required. The inclusion ratio is the fraction of a trust subject to GSTT. If the selling trust is not completely exempt from GSTT, this could have the effect of diluting the purchasing trust's GST-exempt status. This proposal would apply to all post-enactment transactions.

Finally, a taxable termination of a trust is one way that triggers the imposition of GSTT. And under current law, so long as a non-skip person has an interest in the trust, there is no taxable termination. Charitable entities are non-skip persons for purposes of GSTT. Under the proposal, any charitable interest for GSTT purposes would be disregarded for all taxable years after enactment, so that inclusion of these organizations as permissible beneficiaries of the trust would not prevent a taxable termination.

Please reach out to your client relationship manager if you would like an additional information around these issues. We are committed to providing education around fiscal policy and other matters potentially affecting you and your families.

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