

29 SEPTEMBER 2021

Ways and Means Committee Approves Tax Plan that Poses Significant Effects for Future Wealth Transfers

On Wednesday, September 15, the House Ways and Means Committee approved tax increase proposals projected to raise \$2.1 trillion over 10 years (the “Proposals”). If enacted in their current form as part of the broader budget reconciliation bill (the “Bill”), the Proposals would have far-reaching effects on private equity sponsors, their principals, and their portfolio companies.

The Bill faces a number of obstacles in both the House and the Senate, and material changes could be made to the Proposals (including to relevant effective dates) as the legislative process unfolds.

With those caveats, we summarize below at a high level those Proposals that are most relevant to our family office clients, especially those that could significantly affect future wealth transfers as early as the date of enactment of any resulting legislation.

A brief summary of the more relevant changes, as proposed, is below:

- **Capital Gains Tax Rate.** Increases the top long-term capital gains tax rate from 20% to 25%, generally effective for capital gains and qualified dividend income recognized after September 13, 2021, subject to a binding contract exception for transactions that close in 2021.
- **Individual Tax Rate.** Increases the top individual ordinary income tax rate to 39.6%.
- **High-Income Surcharge.** Imposes a 3% surcharge on income (both ordinary income and capital gains) above \$5 million.
- **Carried Interest.** Extends the three-year holding period to qualify for long-term capital gains treatment to five years, except for carried interest attributable to real property trades or businesses. Adds rules for measuring the holding period, including for tiered entities (which in practice may significantly extend the required holding period), and modifies certain other rules. Directs Treasury to issue guidance to address carry waivers and other arrangements intended to avoid the purposes of the provision.
- **Net Investment Income Tax.** Expands the 3.8% net investment income tax to apply to active trade or business flow-through income for high-income taxpayers (above \$500,000 for married filing joint and \$400,000 for single).
- **Corporate Tax Rate.** Increases the corporate tax rate from 21% to 26.5% for corporations with taxable income above \$5 million.
- **Interest Expense Limitation.** Limits interest deductions for certain domestic corporations that are members of an international financial reporting group and whose average excess interest expense over interest income for a three-year period exceeds \$12 million.
- **Carryforward of Disallowed Interest Expense.** Limits the carryforward of certain disallowed interest expense to five years (rather than indefinitely as under current law).

- **Worthless Securities.** Modifies the rules related to worthless securities, including eliminating the ability to treat a loss on a worthless partnership interest as an ordinary loss.
- **Reduction of Gift, Estate, and Generation-Skipping Transfer Tax Exemptions.** Reduction in available gift, estate, and generation-skipping transfer tax exemptions from the current \$11,700,000 to a \$5,000,000, inflation adjusted amount (approximately \$6,000,000). This reduction would apply to post-December 31, 2021 transfers.
- **Treatment of Grantor Trusts.**

First, the proposed new Section 2901 introduces three changes:

- » Assets in “grantor trusts” would be included in the grantor’s estate at death.
- » Distributions from grantor trusts during the grantor’s lifetime are treated as a taxable gift (subject to adjustments for prior gifts).
- » Conversion of a grantor trust to a non-grantor trust during the grantor’s lifetime is treated as a taxable gift (subject to adjustments for prior gifts).

Second, proposed new Section 1062 treats a sale between a grantor and his grantor trust as a taxable sale. This eliminates the possibility for income tax free sales.

The proposal from the Ways and Means Committee says these new provisions would only apply to trusts created on or after the date of enactment and any portion of a “pre-enactment” trust attributable to a contribution on or after the date of enactment. However, we have been told that they are revising the new Section 1062 so that it would apply to pre-enactment trusts as well.

- **Entity Level Valuation Discounts Disallowed.** Entity level valuation discounts would be disallowed for “nonbusiness assets.” These provisions would apply to transfers after the date of enactment.

The proposed legislation is under markup, and much could change before enactment, if anything actually is passed into law. However, given the effective date of certain of these provisions, there is a premium for clients who are able and willing to act now before potential enactment.

Clients may wish to consider at least the following five actions related to their trust and estate plans in advance of any enactment of legislation over the next few weeks:

- 1. Use remaining gift tax exemptions.** Make gifts to new or existing grantor trusts before the exemptions are lowered, and before the treatment of gifts to grantor trusts is changed.
- 2. Fund existing life insurance trusts.** If not otherwise sufficiently capitalized, make gifts to an existing life insurance trust to fund all future premium payments.
- 3. Gift/Sell assets to a grantor trust that still qualify (under current law) for valuation discounts, e.g., interests in family partnership and LLCs.**
- 4. Swap low basis assets currently held in certain existing trusts for high basis assets,** especially in the case of late term grantor retained annuity trusts, or GRATs.
- 5. Pre-paying promissory notes** owed by existing trusts.

Under current law, any of the trusts described in (1) through (3) could include the client’s spouse as a permitted beneficiary. Planning with new trusts that include the spouse as a permitted beneficiary after the date of enactment may be more challenging if the proposed legislation is enacted in its current form. Therefore, clients wishing to complete planning that includes a spouse as a beneficiary should consider acting in advance of enactment of any legislation.

If you wish to discuss taking any of these steps (or others) in light of the proposed legislation, please contact familyoffice@kirkland.com or one of the attorneys listed below.

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