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OCTOBER 2021 CLIENT UPDATE

We hope that you and your family are healthy and safe, given the continued challenges imposed by the pandemic. As we do every year, we are writing to advise you of the current state of the law as it relates to estate planning and to highlight important considerations for you and your family.

Although we have a new President since our last letter, we still lack certainty regarding potential changes in the tax law. As you may be aware, there have been a number of different tax proposals, some from the White House and others from members of Congress. This letter will summarize in general terms the various changes that have been suggested which would have the greatest effect on estate planning and estate and trust taxation. Many of the proposals, if enacted, would have a significant impact on most of our clients and some would dramatically change or severely restrict traditional estate planning techniques.

As you review this letter, please keep in mind that the two proposals which would most impact estate planning in the future are the potential reductions of the estate, gift and GST tax exemptions and the potential elimination of grantor trusts of all kinds.

Accordingly, two broad warnings should be considered as you decide if you need to act immediately to change, implement or accelerate your estate planning:

If you have a grantor trust to which you are considering significant gifts in the future, you may want to make those gifts as soon as possible in case some of the tax proposals limiting future use of grantor trusts are enacted. This would also include possible gifts to “pre-fund” or “endow” trusts which own life insurance to cover the premiums that will need to be made in the future to maintain those policies.

If you plan to make large gifts, to trusts or otherwise, to “lock in” your remaining estate, gift and GST exemptions before the exemptions are reduced as a result of the eventual phase-out in 2025 under the current law, you may want to make those gifts as soon as possible, and before the end of 2021, in case the proposals reducing those exemptions as of January 1, 2022 are enacted.

There are other proposals discussed in this letter, including potential changes to capital gains taxes, income taxes and retirement plans, which are important but may be difficult to plan around at this point, particularly because their effective dates may have already passed. Consequently, taking action now would not assist in alleviating the impact of those proposals.

As you read the balance of this letter, please note that many of the tax proposals being discussed in Washington have been raised, without becoming law, in prior years as well. With all of the issues facing legislators in Washington this Fall, it is possible that consensus on major tax legislation will not be reached. Accordingly, a number of these proposals may again be put aside for future consideration. However, some of the tax legislation has been “fast-tracked” in Congress so past inaction may not be an indication of whether these proposals might finally be enacted and become law in the coming weeks.

CURRENT AND FUTURE FEDERAL ESTATE, GIFT AND GST TAX RATES AND EXEMPTIONS

Year	Exemption	Rate
2021-2025	\$11,700,000*	40%
2026	\$5,930,000*	40%

*as indexed for inflation

PROPOSED LEGISLATIVE CHANGES

The major tax proposals that have been introduced this year include Senator Bernie Sanders’s “For the 99.5 Percent Act” (“Sanders Proposal”) introduced on March 25, 2021, the Sensible Taxation and Equity Promotion or “STEP” Act introduced on March 29, 2021, the Biden Administration’s Green Book, released on May 28, 2021, which is an explanation of the tax proposals in the Biden Administration’s Budget for 2022 (“Biden Proposal”) and, perhaps most importantly, the legislation proposed by the House Ways and Means Committee for possible inclusion in the Build America Back Better Act (“House Proposal”). Released to the public on September 13, 2021, the House Proposal is more sweeping in nature than the other proposals and is currently slated to move through the legislative process quickly if it garners enough votes. Because we do not yet know which, if any, of the proposals will become law, we will highlight the possibilities under the proposals most likely to affect you with regard to trusts and estates planning if enacted.

Federal Estate and Gift Tax Exemptions and Rates: The Sanders Proposal reduces the estate tax exemption to \$3,500,000 and the gift tax exemption to \$1,000,000, excluding gifts made prior to the proposed change in law and the annual exclusion amount of \$15,000 per person (or \$30,000 for gifts by a married couple). The Sanders Proposal also imposes progressive estate tax rates, including 45% for estates over \$3,500,000, 50% for estates over \$10,000,000 and reaching as high as 65% for estates over \$1 billion. The House Proposal maintains the current rates and unified estate and gift exemptions but accelerates the sunseting of the temporary increase in these exemption amounts, reducing them to their pre-2018 level of \$5,000,000, indexed for inflation from 2010 (approximately \$6,000,000 as of January 1, 2022). The Biden Proposal does not address estate and gift taxes specifically.

Tax Treatment of Grantor Trusts: One popular planning technique is for an individual (the “grantor”) to make gifts to a “grantor trust” which, under current law, not only excludes the gifted assets from the grantor’s taxable estate at death but allows the grantor to further reduce his or her taxable estate by remaining obligated to pay income taxes on income earned on the assets in the grantor trust. It is difficult to create many kinds of gifting trusts without having them treated as “grantor trusts.” This is particularly true if the spouse of the grantor will be a beneficiary or a trustee of the trust.

- **Estate Tax Inclusion of Grantor Trusts:** The Sanders Proposal and the House Proposal both (1) treat grantor trusts as includible in the grantor’s taxable estate at death and (2) subject any distributions from grantor trusts to trust beneficiaries (other than the grantor or the grantor’s spouse) during the grantor’s life as gifts subject to the federal gift tax. Under the House Proposal, the new rules would apply to all grantor trusts created *after* the date of enactment *and* to portions of grantor trusts created *before* the date of enactment if any contributions are made to those trusts after the date of enactment. As such, the House Proposal effectively eliminates the use of newly created grantor trusts, including most Life Insurance Trusts, Spousal Estate Reduction Trusts (sometimes called “SLATs”), Grantor Retained Annuity Trusts (“GRATs”) and Qualified Personal Residence Trusts (“QPRTs”), as estate tax avoidance vehicles. To be clear, although grantor trusts created and funded prior to the date of enactment of the law would be grandfathered, additional contributions to such grandfathered trusts, such as premium payments, and ongoing transactions between the grantor and the grantor trust, such as loans and leases, may have undesirable income and estate tax consequences. For clients who still need to pay premiums on policies owned by existing Life Insurance Trusts, the House Proposal’s change to the grantor trust rules would present a significant challenge. Unless a carveout for payments of insurance premiums is added to the legislation (as it was in other proposals), each premium paid by a grantor after the date of enactment would chip away at the estate tax savings afforded by the Life Insurance Trust.
- **Capital Gains on Sales to Grantor Trusts:** In some cases, clients who have used most or all of their available gift tax exemptions may “freeze” the value of an asset with perceived appreciation potential by selling the asset to an existing grantor trust in return for an interest-bearing promissory note. After the sale, any appreciation in the sold asset would accrue to the trust beneficiaries outside of the grantor’s taxable estate. Because the grantor is the deemed owner of a grantor trust for income tax purposes, the sale is disregarded for income tax purposes -- the grantor does not recognize gain or loss on the sale and does not pay income tax on the interest payments received pursuant to the terms of the promissory note. Without this crucial income tax feature, few taxpayers would engage in this powerful transaction. Under the House Proposal, effective on the date of enactment, sales to grantor trusts would no longer be disregarded for income tax purposes and would instead be treated like any other arms-length sale (i.e., subjected to capital gains tax).

Proposals relating to the Generation-Skipping Transfer Tax (“GST Tax”) and longer term trusts: Under current law, assets passing from a grandparent to a grandchild, either directly or by trust, are subject to a generation-skipping transfer tax of 40%, but each individual has an

\$11,700,000 exemption from this generation-skipping transfer tax (“GST Exemption”). This means that, through proper planning, clients can use their GST Exemptions to fund trusts to benefit multiple generations without the imposition of transfer tax (“GST Trusts”). Currently, GST Trusts may last as long as state law permits: 800 years in Connecticut, 360 years in Florida and, in simple terms, approximately 100 years in New York. The Sanders Proposal limits GST trusts to 50 years and applies GST Tax at the end of such 50 year period. In addition, the Sanders Proposal increases the GST Tax rate from 40% to 65%. The STEP Act includes a proposal to tax unrealized appreciation of trust assets every 21 years. Where a trust holds property which has not recognized gain in 90 years (from a start date of January 1, 1940), the Biden Proposal provides that such gain must be realized and subjected to capital gains tax at the end of such 90 year period (or as early as December 31, 2030). While the House Proposal does not contain any provisions limiting the duration of GST Trusts or causing recognition of gain on unrealized appreciation after a period of years, the House Proposal reduces the GST Exemption to its pre-2018 Tax Act amount of \$5,000,000 indexed for inflation since 2010 (or approximately \$6,000,000 in 2022) effective December 31, 2021, which is consistent with the proposed changes to the federal estate and gift tax exemption.

Proposal to Eliminate Discounts on Certain Closely-Held Business Interests: Many clients create Limited Liability Companies or Family Limited Partnerships to hold and manage real estate and/or marketable securities. As part of their estate planning, clients often gift ownership interests in these entities to family members at discounted gift tax values which would not otherwise apply if the assets were gifted outside of such entities. Each of the Biden Proposal, the Sanders Proposal and the House Proposal includes provisions which reduce or eliminate lack of control and lack of marketability discounts for these types of family-owned businesses, with the House Proposal specifically targeting entities which own assets that are not used in the conduct of an active trade or business.

Elimination of “Step-Up” in Basis and New Triggers of Gain: Under current law, assets owned by a decedent at death receive a “stepped up” or new basis for capital gains tax purposes equal to the assets’ value on the date of death. While the House Proposal does not change the step-up in basis provisions of the tax law, the Biden and Sanders proposals would eliminate this step-up in basis of a decedent’s assets at death. In addition, both proposals go further, requiring gain to be recognized for capital gains tax purposes at death. If adopted, these changes would have a major impact on planning. Many people often hold low basis assets until death, even when they have a concentrated position of stock, in order to reduce the capital gains tax consequences upon sale by obtaining a step-up in basis at death. With regard to gifting, capital gains would also be triggered upon a transfer by gift of appreciated assets. Under the Biden Proposal, a gift of appreciated property (excluding gifts to charity or a spouse) would cause gain to be recognized immediately, subject to a \$1,000,000 lifetime exclusion. Transfers of property to and distributions of property from irrevocable trusts would also cause recognition of gain under these proposals. All of these changes to step-up and recognition rules for capital gains taxes would be even more significant if capital gains tax rates increase, as discussed below.

Changes in Income and Capital Gains Tax Rates: The Biden Proposal includes increasing the long-term capital gains tax rate and qualified dividends income tax rate from 20% to 39.6% (plus the 3.8% net investment income tax) for individuals whose annual income exceeds \$1,000,000.

The Biden Proposal also includes taxing carried interests as ordinary income (if the taxpayer's taxable income exceeds \$400,000). The House Proposal increases the top individual income tax rate from 37% to the pre-2018 Tax Act rate of 39.6% while reducing the income level at which such rate would apply to (i) \$450,000 for married couples, (ii) \$425,000 for heads of households, (iii) \$400,000 for unmarried individuals and (iv) \$12,500 for trusts and estates. The House Proposal also includes a new surcharge of 3% on gross income less certain adjustments, such as retirement contributions and certain investment expenses, of high income individuals with adjusted income in excess of \$5,000,000 and trusts and estates with adjusted income in excess of \$100,000. In addition, effective as of September 13, 2021, the House Proposal increases the top capital gains tax rate to 25% (plus the 3.8% net investment income tax which is also expanded to include income derived in the ordinary course of business for high-income taxpayers and distributions from pass-through entities). For those individuals who have benefited from the long-term capital gains tax treatment of carried interests, the House Proposal increases the holding period for long-term capital gains tax treatment from 3 to 5 years.

Effective dates: Of course, the million dollar question is when these proposals, if adopted as law, would apply. The Sanders Proposal is not retroactive and would be effective January 1, 2022. The STEP Act has a proposed retroactive effective date of January 1, 2021. The most impactful provisions of the Biden Proposal would be effective January 1, 2022, though the increase in the capital gains tax rate is proposed as retroactive to April 28, 2021. Under the House Proposal, changes to the estate, gift and GST exemptions have an effective date of December 31, 2021. Likewise, most changes to the income tax rules under the House Proposal have a proposed effective date of December 31, 2021 with the following notable exceptions: (1) the increase in the capital gains tax rate has a proposed effective date of September 13, 2021 (the date of introduction of the bill); and (2) the changes to the tax treatment of sales to grantor trusts would be effective on the date of enactment of the law. In addition, the new gift and estate tax treatment of grantor trusts and the elimination of valuation discounts on the transfer of nonbusiness assets also would be effective on the date of enactment of the law.

Considering the fundamental unfairness of a retroactive application of proposed laws, especially this late in the calendar year, many legal analysts do not believe any of these proposed laws would apply retroactively to the beginning of 2021. We agree that there is low risk of such a result. However, because the laws could go into effect on the date of introduction, the date of enactment, or on January 1, 2022, it is important to consider whether you are comfortable taking action to plan around the impact of proposed changes that can be avoided by acting now, despite any risks you take in doing so.

OTHER CONSIDERATIONS RELATING TO GIFTING NOW

When making gifting decisions, remember to consider capital gains and state tax implications:

- Connecticut has a separate state gift tax with an exemption of \$7,100,000 in 2021. This means that if a Connecticut resident who has not used any gift exemption previously makes a \$11,700,000 gift to take full advantage of the federal gift exemption available this year, a Connecticut gift tax of \$528,000 will be due on the \$4,600,000 difference between the federal and Connecticut exemptions. (This exemption increases to

\$9,100,000 in 2022.) Note, however, that this tax can be avoided if the gift involves real property or tangible personal property located out-of-state, as such property located outside of Connecticut is not subject to Connecticut gift tax. Conversely, gifts by non-residents of real property and tangible personal property located in Connecticut are subject to Connecticut's state gift tax.

- New York does not have a gift tax but does have an estate tax with an exemption of \$5,930,000 in 2021. This means a New York resident who has not used any gift exemption in the past can gift up to \$11,700,000 during 2021 and pay no federal or New York gift tax, while the same transfer at death would incur a \$1,338,800 New York estate tax. (Note, however, that gifts made within three years of death are brought back into a New York resident's estate for purposes of calculating New York estate taxes.)
- Florida has no separate state gift or estate tax.
- Under current law, gifting can result in a trade-off of capital gains tax savings for estate and gift tax savings because gifted assets retain the donor's cost basis.

WHO SHOULD CONSIDER GIFTING BEFORE THE END OF 2021?

- Clients who are certain they will never need the gifted assets and can maintain financial independence without those assets and the income they may generate.
- Clients who believe the property they gift will appreciate in value before death.
- Clients who are willing to proceed on their belief that federal tax exemptions soon will be reduced below the current level for a prolonged period of time.
- Clients who are willing to gift the entirety (or at least the majority) of their exemption now. If you wish to hedge against future reductions in the exemptions, you must give enough now to use what might be taken away. For example, if you currently have \$11,700,000 in exemption, you make a gift of \$8,000,000 now and the exemption is later reduced to \$5,000,000, you will have given away an extra \$3,000,000 without the imposition of transfer tax. On the other hand, if, under the same circumstances, you make a gift of \$4,000,000 now, the \$4,000,000 will be applied against the reduced exemption of \$5,000,000, leaving you with \$1,000,000 of exemption remaining -- the gift will not be taken "off the top" of the higher exemption amount; it will simply be applied against the reduced exemption amount. That means that making large gifts now is the only way to capture or "lock in" the difference between the current historically large exemption amount and the amount to which the exemption may be subsequently reduced.
- Clients who can afford to pay gift tax in the unlikely event of a retroactive reduction of the federal gift tax exemption.
- Clients who are considering pre-funding their life insurance premiums on policies owned by Life Insurance Trusts.
- Clients who are considering sales to grantor trusts or gifts to grantor trusts, such as GRATs, QPRTs and Spousal Estate Reduction Trusts.

RECENT CHANGES AND PROPOSED ADDITIONAL CHANGES AFFECTING RETIREMENT ASSETS

Recent changes to Retirement Plan rules: As a reminder, the Coronavirus Aid, Relief and Economic Security (CARES) Act suspended required minimum distributions ("RMDs") for 2020 for retirement plans such as 401(k)s, 403(b)s, 457(b)s, SEP IRAs, Simple IRAs, and traditional

and inherited IRAs. An RMD is the amount that must be withdrawn by the participant/account-owner when the participant/account-owner has reached a certain age or by the beneficiary of an inherited retirement plan. This change only applied in 2020, meaning that in 2021 and beyond RMDs again must be taken by the participant/account-owner (while a different set of rules applies to the beneficiaries of a deceased participant/account-owner as explained below). However, the RMD calculations will change beginning on January 1, 2022, as new life expectancy tables will apply to the calculation of RMDs to be taken from retirement accounts, reflecting longer life expectancies.

In addition, as discussed in our prior letters, the Setting Every Community Up for Retirement Enhancement (“SECURE”) Act, enacted at the end of 2019, significantly changed the rules for inherited retirement accounts, including increasing the required beginning date for a plan participant/account-owner to age 72. The most notable change under the SECURE Act was to require individual beneficiaries, other than a surviving spouse, to draw down the entire account balance no later than December 31st of the year containing the 10th anniversary of the participant/account-owner’s death rather than over the beneficiary’s life expectancy. This treatment has the likely effect of accelerating the income taxes due on the distributions and minimizing the amount of appreciation that occurs on a tax-deferred basis. There is no required distribution schedule for the 10-year period, but the entire account must be withdrawn by the 10-year mark. There are some exceptions for minor children of the participant (whose 10-year draw down window begins when they reach the age of majority), disabled or chronically ill beneficiaries, and beneficiaries not more than 10 years younger than the deceased owner. Most importantly, the 10-year draw down is only available to certain types of trusts named as beneficiaries. Otherwise a 5-year draw down will apply to trusts named as beneficiaries of retirement plans.

Proposals affecting Retirement Plans: The House Proposal imposes contribution limits and new required minimum distributions for high-income “applicable taxpayers” with large retirement account balances. An “applicable taxpayer” is described as a taxpayer whose “adjusted taxable income” for a particular taxable year exceeds: (i) \$400,000 for an individual who is not described in (ii) or (iii); (ii) \$425,000 for an individual who is a head of household; and (iii) \$450,000 for an individual who is married filing jointly or a surviving spouse. Effective for tax years after December 31, 2021, regardless of the age of the taxpayer, if the aggregate value of the applicable taxpayer's retirement accounts exceeds \$10,000,000 (in 2022 and indexed for inflation thereafter) at the end of the prior tax year, the applicable taxpayer (1) may not make further contributions to the retirement accounts, (2) must take a distribution from the retirement accounts equal to 50% of the amount by which the aggregate value of the accounts exceeds \$10,000,000 and (3) to the extent that the aggregate value of the retirement accounts exceeds \$20,000,000 (in 2022 and indexed for inflation thereafter) and includes Roth retirement accounts, must take an additional distribution from the taxpayer’s Roth retirement accounts of the lesser of (a) the amount necessary to reduce the aggregate value of all retirement accounts to \$20,000,000 or (b) the balance held in the taxpayer’s Roth retirement accounts. In addition, the House Proposal eliminates Roth conversions for applicable taxpayers (effective for tax years after December 31, 2031) and eliminates after-tax contributions to qualified plans and Roth conversions for all taxpayers regardless of income level if any portion of the amount converted consists of after-tax contributions (effective for tax years after December 31, 2021).

FLORIDA COMMUNITY PROPERTY TRUSTS

Most states in the United States, including Connecticut, Florida and New York, are not community property states. This has often been viewed as an income tax disadvantage for married couples. As a simple example, if spouses residing in a state that is not a community property state own appreciated property jointly, only one-half of the property receives a step-up in basis at the death of the first spouse to die. On the other hand, if such property is recognized as community property, 100% of the property receives a step-up in basis at the death of the first spouse to die, permitting the property to be sold by the surviving spouse without paying capital gains tax on any of the pre-death appreciation. As of July 1, 2021, Florida became the fifth state to permit the creation of Community Property Trusts. This new law may present a valuable estate planning opportunity for spouses in non-community property states who have property with substantial unrealized gains and who are either (i) Florida residents or (ii) non-residents willing to appoint a Florida resident as Trustee of a Community Property Trust. Florida's enactment of this new law allows married couples who have highly appreciated property to receive a full step-up in basis at the first of their deaths by transferring appreciated property to a Florida Community Property Trust before the first death. There are specific provisions which are required for a trust to qualify as a Florida Community Property Trust. If the spouses are Florida residents, one or both of them may act as Trustee. If not, the trust must have a "Qualified Trustee" who is a resident of Florida or a bank or trust company authorized to act as a Trustee in Florida. Please contact your Cummings & Lockwood attorney if you are interested in discussing whether or not converting property to community property by establishing a Florida Community Property Trust is appropriate for you.

FLORIDA DIRECTED TRUSTS

Effective July 1, 2021, the Florida Uniform Directed Trust Act permits the creation of directed trusts. The grantor of a directed trust may give a person other than a Trustee (the "trust director") powers under a trust agreement which would normally be held by the Trustees and require that the Trustees follow the trust director's directions in exercising these powers. A common example is a grantor giving the trust director the power to direct investment of trust assets, particularly when the trust owns specialized assets such as closely-held business interests. Alternatively, a trust director might be empowered with decisions about when to make or not make distributions to a particular beneficiary. If a Trustee must follow the directions of the trust director, the Trustee's liability is limited for acting in accordance with those directions. Instead, the trust director is generally held to the standards of fiduciary duty and liability that otherwise would apply to the Trustee. However, the trust can be drafted to increase or reduce, but not eliminate, the trust director's liability. This division of responsibilities provides flexibility for clients and also provides a method for reducing Trustee fees if the Trustee acts in a mainly administrative role following instructions from a trust director.

PLANNING FOR YOUR CHILDREN AS THEY REACH ADULTHOOD

When children reach age 18, they become legal adults, which means that they make their own health care decisions and, in most cases, have responsibility for their own finances. In order to retain access to your adult child's medical records, you would need your child to sign a document

entitled “Authorization for Use and Disclosure of Protected Health Information” permitting health care providers to share your child’s medical information with you. In addition, your child should consider signing a Living Will and appointing a Health Care Representative to make medical decisions if he or she is unable to do so. Finally, your child should consider signing a Power of Attorney giving you (or another trusted adult) the ability to handle financial matters on his or her behalf when necessary. If your child is a college student, you should check with your child's college or university to determine whether school forms or state-specific forms are also required for these purposes.

You or other family members may have gifted to Uniform Transfers to Minors Act (“UTMA”) or Uniform Gifts to Minors Act (“UGMA”) accounts for your child in past years, and the values of these accounts may have reached meaningful levels such that you are concerned about the child receiving the funds at age 18, 21, or 25 (depending on the State where the account is located and the account documents when it was created). You may wish to speak with your Cummings & Lockwood attorney about options your child might consider in order to protect himself or herself by delaying the age at which the child receives the UTMA or UGMA funds outright and permitting you to manage funds for him or her for a longer period of time.

NEW PALM BEACH GARDENS OFFICE WITH EXPANDED PROBATE LITIGATION CAPABILITIES

In July 2021, we moved our Palm Beach Gardens office to larger space in the Seacoast Banking Centre in Palm Beach Gardens across PGA Boulevard from the North County Courthouse. This will allow us to further expand our trusts and estates practice in the Palm Beach area. In addition, Michael Kaelin, a principal in our litigation group and an experienced probate litigator in Connecticut, is now admitted in Florida and handling trusts and estates disputes in both Connecticut and Florida. When working in Florida, Michael is based in the expanded Palm Beach Gardens office so that we can now more effectively provide litigation services to our Florida clients on both the East and West Coasts.

We recognize that news out of Washington with regard to changes to the tax law can come at any time and legislation can be proposed and enacted quickly. We continue to monitor all of the developments and will post alerts on our website (www.cl-law.com) with any major developments, as well as a summary of the relevant provisions of any final tax law that is enacted. In the meantime, please feel free to contact your Cummings & Lockwood attorney with any questions.