Austin Landline Report
October 2021

Important Estate and Income Tax Changes Coming

As part of STPRA's 2021 focus on taxation, we want to make you aware of HR 5376, which is the Democratic Majority's tax law proposal to be incorporated into the budget reconciliation bill currently being considered in Congress. As a reconciliation bill, it requires no Republican votes to pass, so long as every Democratic Senator supports the measure. It is important to know that while this is not final legislation, it does have to support of Democratic leadership in both houses of Congress and is likely to pass sometime before the end of this year, and possibly as early as this month.

Estate Tax Exemption Slashed
Based upon the House Proposal, the current $11.7 million gift and estate tax exemption could be reduced to approximately $6.03 million after December 31, 2021. This will greatly impact the ability of South Texas landowners to pass their land to their children without incurring a 40% estate, gift, and generation-skipping transfer tax. There are currently tools, such as grantor trusts, which estate planning professionals use to minimize estate tax liability, but the Proposal eliminates these as of the effective date of the legislation. The provision eliminating the use of grantor trusts is generally effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date. Thus it is important that landowners act now to (1) create any trusts to transfer property interests and (2) actually transfer that property to the trusts prior to the bill's passage.

Family Limited Partnership and Other Valuation Discount Limits as Non-Business Assets
The House Proposal seeks to limit the estate and gift tax valuation discounts applied to transfers of closely-held non-business assets. This provision is designed to limit the strategy of creating family limited partnerships to hold passive assets (such as real estate not in an active business and have the partnership valued for gift and estate tax purposes at a lesser value due to discounts for lack of marketability and minority interests. The Proposal defines non-business assets as passive-type assets, which are held for the production or collection of income and are not used in the active conduct of a trade or business.

This provision, if enacted, would apply to transfers after the date of enactment. Included in the valuation discount prohibition rule is passive real estate held in partnerships and LLCs. Currently, it appears that fractional gifts of interests in individually owned real estate (not owned in a business entity) could still qualify for valuation discounts, but such transfers could create catastrophic title issues such as where one owner of a small fractional interest does not agree to a sale, making this an ineffective estate planning tool.

Income Taxes Increased
The top marginal individual income tax rate would increase from 37% to 39.6%. This marginal rate would apply to married individuals filing jointly with taxable income over $450,000; to

heads of household with taxable income over $425,000; to unmarried individuals with taxable income over $400,000; to married individuals filing separate returns with taxable income over $225,000; and to estates and trusts with taxable income over $12,500.

The House Proposal would impose a surcharge tax equal to 3% of a taxpayer's modified adjusted gross income (MAGI) in excess of $5 million (or in excess of $2.5 million for a married individual filing separately). For this purpose, modified adjusted gross income means adjusted gross income reduced by any deduction allowed for investment interest (as defined in section 163(d)). Note however, that if you sell a highly appreciated piece of property, you could be hit with both capital gains tax increase, and the surcharge tax, as well unless you use vehicles like a 1031 exchange to immediately reinvest those proceeds into other property.

Capital Gains Rate Increased

The House Proposal would increase the 20% tax rate on capital gains to 25%, effective for tax years ending after September 13, 2021 (note that President Biden had considered a 40% capital gains tax). However, a transition rule would provide that the current statutory rate of 20% would continue to apply to gains and losses for the portion of the tax year prior to September 13, 2021 and gains recognized after September 13, 2021 that arise from transactions entered into before September 13, 2021 pursuant to a written binding contract (and which is not modified thereafter in any material respect). Most capital gains are also subject to an additional 3.8% tax. Note that the way the bill is drafted this effective date has already passed, so there is little that can be done at this point to structure transactions to minimize the impact of this proposal.

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