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If Enacted, Proposed Legislation Will Completely Change the Taxation of Capital Gains

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Our current tax system is structured so that we pay income tax on our earnings, investment income, and distributions from retirement plans. However, federal capital gains tax on an appreciated asset such as a home, business or stock is postponed until the asset is sold. Under current law, upon the death of an individual, the decedent's assets get a so-called "Step Up in Basis" to the fair market value at death. When an asset is sold for the value at death, an asset's increased value at death is not subject to income tax.

Senator Chris Van Hollen, supported by Senators Cory Booker, Bernie Sanders, Sheldon Whitehouse and Elizabeth Warren, has introduced a bill called the "Sensible Taxation and Equity Promotion (STEP) Act, which, if passed, will eliminate the "Step Up in Basis" in most situations and result in deemed sales upon certain transfers. Specifically, the following transfers will trigger the realization of Capital Gains tax, subject to some exceptions:

- Transfers at death, including transfers to trusts.
- Transfers to irrevocable trusts, including transfers to so-called "intentionally defective grantor trusts" (IDGTs).
 - Note, it is uncertain as to whether this would apply to so-called "grantor retained annuity trusts" (GRATs).
- Outright gifts in excess of the annual exclusion amount (currently \$15,000 per donee).
- Investments and other property held in trust will be deemed to be sold every 21 years causing taxable gain on any unrealized appreciation.
 - Trusts created in 2005 or earlier will have gain triggered in 2026.

- Although it is not clear how a substitution of assets in a trust will be treated, it appears it would not be subject to taxation under the bill.

The taxation of such transfers would be subject to the following exclusions and exceptions:

- \$1,000,000 lifetime exclusion (adjusted for inflation) for unrealized gains at death
 - Individuals may use \$100,000 of their \$1,000,000 exclusion for gifts made during their lifetime.
- \$250,000 (\$500,000 for married couples) exclusion of gain from transfer of personal residences.
- Transfers made to spouses or to certain trusts for a spouse's benefit, assuming the spouse is a U.S. citizen.
- Donations to charity – for example, gifts to Charitable Remainder Trusts are not taxable.
- Property not subject to tax when transferred between grantors and their grantor trusts (other than IDGTS).
 - Grantor trust property will be deemed sold upon distribution of the trust property, the death of the grantor or the termination of grantor trust status for other reasons.

Note, for transfers of unrealized gain upon death, or under the 21-year rule for non-grantor trusts, the income taxes may be paid over 15 years. This is not the case, though, for lifetime gifts. Most significantly, **the STEP Act is retroactive to transfers taking place after December 31, 2020**. It is uncertain whether the retroactivity is constitutional, however several experts believe that the STEP Act would likely be held constitutional if it is deemed to be a legitimate purpose of government, which may be the case given the large amount of spending by Congress due to the pandemic.

A comparable bill was introduced in the House by Representative Bill Pascrell from New Jersey that would not be retroactive to 2021 and have the automatic realization of gain every 30 years instead of 21 years.

The Step Act has been introduced along with the "For the 99.5% Act" (which Rubin and Rudman covered in our April 14, 2021 [Client Alert](#)), as well as proposals introduced by the Biden administration. These other proposals include substantial corporate tax increases, the maximum tax rate increased to 39.6%, the capital gains rate increase to 39.6% for wealthier individuals, a \$500,000 cap on Section 1031 exchanges, and significant funds (billions of dollars) to the IRS to increase tax audits and collection efforts. The STEP Act and For the 99.5% Act proposals have been introduced in the

House and Senate; however, have not been debated in either chamber. With all these proposals, many estate and tax planners suspect that the STEP Act will not be enacted, and if it is, will have considerable modifications.

Some of the following planning ideas are being considered in this sea of uncertainty:

- Use the balance of your estate tax exemption by utilizing planning techniques such as GRATs, SLATs and sales to intentionally defective grantor trusts to lock in discounts even though they may not be effective. Many planners believe that these techniques will not be lost to retroactivity.
- Gift cash only, which will avoid recognition if the STEP Act is enacted. If you do not have liquidity, borrow to enable you to make cash gifts.
- Consider gifts to charities, including charitable trusts.
- To mitigate possible retroactivity, consider use of rescission/disclaimer provisions in a will or trust for any transaction completed in 2021. Note, this technique may work for estate and gift tax purposes, but not income tax purposes.
- Consider a marital trust technique by which, if the STEP Act is not enacted, the spouse can disclaim his/her interest into a discretionary family trust. If the STEP Act is enacted, then the assets would be in a marital trust and it will not cause recognition of gain due an exception in the Act for marital trust transfers to a US citizen spouse.

Conclusions: Looking at the history of the passage of tax bills, it is most likely that any changes will take effect for 2022, or possibly at an earlier time if Congress passes a comprehensive bill sooner. The bill, once passed, will include provisions that have been debated and compromised. Given the uncertainty about what the final bill will look like, our gift, estate and income tax planners recommend you utilize the planning techniques that are available now if one or more make sense based on your individual situation. As we suggested in our April 14th Client Alert, if you are interested in completing or updating your estate plan, please let us know as soon as possible so we have sufficient time to complete your planning and draft documents prior to enactment of proposed legislation.

For more information, please contact your Rubin and Rudman estate planning attorney or, if you do not have one, we will refer you to one of the attorneys in our [Trusts and Estates Department](#).

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