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House Estate Tax Proposal Requires Immediate Action

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Recent Proposal

The House Democrats are proposing a $3.5 trillion spending plan. To support that package the Democrats have proposed tax increases to fund a large portion of that plan. The House Ways and Means Committee just issued statutory language for the tax increase proposal. While the tax legislative process will no doubt evolve with many twists and turns, these proposals might well be the blueprint for any final legislation. The implications of this are quite simple. Taxpayers who might be affected need to plan and take action now. If you've been sitting on the tax planning fence waiting to see what will be enacted, this proposal suggests you jump off the fence and plan with haste. This article will explain some of the "why" and "how." Keep in mind, there remains incredible uncertainty, but inaction might prove the costliest option for some.

Overview of What the House Proposal Does and Doesn't Include

This article will focus on estate planning changes, and actions you should consider with your advisory team now. But, some discussion of income tax changes is necessary as many of the income tax changes will have an impact on your estate tax planning. As expected, individual and corporate income tax rates will increase. What might be unexpected is the many different ways that

taxes will be increased. The manner in which some of these changes are applied to trusts, the foundation of much of estate planning, is particularly harsh. Taxpayers contemplating immediate transfers to trusts for estate tax purposes, must also consider these income tax rules. Restrictions will affect retirement accounts as well.

Capital gains rates will be increased, but not as bad as being taxed at ordinary income rates.

From an estate tax perspective, the exemption will be cut in half, grantor trusts which have been the cornerstone of estate planning will be dramatically restricted, and valuation discounts which have been the elixir for many estate plans will be restricted.

Noticeably absent from the proposal are a host of changes that had been discussed. This includes the so-called “deemed realization” rules that would trigger capital gains tax gifts of appreciated assets, on death, or the transfer of assets from certain trusts. The adjustment of tax basis on death remains part of the law although many had anticipated its elimination. Thus, heirs who inherit appreciated assets will have that appreciation added to the tax basis so that a later sale will still not trigger gain (so long as there is no appreciation from date of death until the date of sale). That had been identified as a major loophole benefiting the wealthy, but it was not addressed. Some of the restrictions on dynastic trusts that had been included in the Sanders plan seem absent. But before wealthy taxpayers feel relief, consider that this proposal must wind its way through the Senate and any of these more restrictive changes could be added there. Easing the restrictions on deducting state and local taxes that had been introduced in the 2017 tax legislation was not included.

Effective Dates

When the proposals become effective is critical to determining if you have time to plan before the law changes, and how much time that might be. While many changes apply to tax years beginning after December 31, 2021, i.e., for most provisions they are to become effective in 2022, this is not true for all changes. 2022 is a common effective date for many provisions but caution is in order. There are significant provisions in the House proposal that have earlier effective dates. The discussions following will identify the proposed effective date of many provisions and explain the possible implications of those effective dates for planning. The bottom line for many planning steps is that you should act immediately and urgently. Uncertainly remains. Some critically important provisions to estate planning are pegged to become effective on the date of enactment. But when might that be?

Increased IRS Funding

The house proposal would appropriate nearly $80 billion to the IRS to improve taxpayer compliance with tax laws. The CBO estimates this would make the IRS's 2031 budget 90% larger than its current baseline projection and would double staffing. The CBO estimates 75% of this additional funding would be allocated to enforcement. This is estimated to increase revenue by $200 billion over 10-years. That means lots more audits, more comprehensive audits, and perhaps audits that are broader in scope looking at personal, entity, trust and gift tax returns in a holistic manner that might help examiners identify issues that are less apparent when only a single return is audited. Some have speculated that under current IRS funding only about 1-2% of gift tax returns are audited. That percentage could jump if this change is

enacted. For those taxpayers who have been on the aggressive side relying on low audit rates to slip under the IRS scrutiny, it will be a new world.

Caregiver Expenses New Credit

There are several provisions in the House proposal that are helpful to taxpayers, and in particular to lower income taxpayers. This is one such example and this income tax credit could have important estate and related planning implications for lower income aging taxpayers. A tax credit will be provided, up to $4,000, for 50% of qualified expenses incurred caring for relatives living at home unable to perform the activates of daily living. This tax benefit will be phased-out if the taxpayer's income exceeds $75,000. Thus, for lower income taxpayers this will take the edge of care costs for those living with chronic illness, other health issues and the challenges of aging.

Increase in Individual Income Tax Rates

The highest or "marginal" individual income tax rate increases to 39.6%. This rate would apply to married individuals filing joint tax returns with taxable income over $450,000, and to unmarried taxpayers with taxable income over $400,000. For many of the proposed changes the $400-$450,000 level of income is the demarcation of what is considered in the proposal to be high income and thus subject to higher tax changes, not only this change in rates. While this change will no doubt raise revenue this increase in rates alone may not trigger significant planning. Although, if you were to contemplate a Roth conversion it would be advantageous to do so before this rate increase becomes effective. But this higher income tax rate is even more significant when taken together with all the other tax increases on the wealthy discussed below. The many changes overall will be substantial for many taxpayers. For

example, see the 3% surtax, increase in net investment income taxes, reduction in 199A deduction, etc.

This increase in income tax rates, as well as other income tax rate changes discussed below, have critical importance to estate planning. The highest rate applies to estates and trusts with taxable income over $12,500. That is a tiny fraction of the income level at which the highest rates apply to individuals, e.g., the family members who may be beneficiaries of an irrevocable trust. For estates and trusts in 2021 it may be worth accelerating income while rates are lower. For so-called complex or non-grantor trusts that pay their own income tax (e.g., a credit shelter trust funded on the death of a spouse) distributions may carry out income to the beneficiary and thus be taxed at a lower rate. So, the benefits of a possibly lower tax rate should be weighed against the provision of funds outright to a beneficiary (is the beneficiary responsible?) and the inclusion of those funds in the beneficiary's estate if the distributed funds are not spent. Consider the implications of this to an accumulation trust created post-Secure Act. The Secure Act changed the rules applicable to retirement plans effectively eliminating the stretch-IRA. As a result, some taxpayers made funds payable to trusts to protect the beneficiaries of their plan assets. However, if all plan assets are distributed at the end of the 10th year following your death (as the plan holder) those funds are more likely to hit the new highest rate (and see the surtax discussion below).

This change applies to tax years beginning after December 31, 2021.

Sec. 138201 changing Sec. l(j)(2).

Tax Surcharge on High Income Individuals, Trusts, and Estates

A further increase in marginal income tax rates applies to certain high income taxpayers. Perhaps the idea was to make it appear, for political optics, that the maximum tax rate is only 39.6% as discussed above, when in fact the actual rate is 42.6%. This new provision imposes an additional tax of 3% of a taxpayer's modified adjusted gross income ("MAGI") in excess of $5 million for married taxpayers filing joint returns. This provision is just another example as to the greater increase in tax rates for high income taxpayers beyond the 39.6% rate noted above.

The MAGI figure for trusts and estates is $100,000. This will thus, at a relatively low income level, subject trust income to a very high 42.6% tax rate. State and local taxes (and other changes in the House proposal) may make that effective tax rate even higher. Consider the impact of this in light of retirement assets paid to trusts. The Secure Act, as noted above, may have resulted in some plan holders changing beneficiaries to trusts because of the elimination of the stretch IRA. The Secure Act requires the payout of the full plan balance at the end of the 10th year following the death of the plan holder. That will for many plans result in a very high tax rate of 42.6% on those plan balances. If the funds were instead distributed to a beneficiary, the marginal tax bracket might be only 22% or about half. That is a tremendous difference and will require careful consideration of naming trusts as beneficiaries. That creates a particularly nettlesome dilemma for you if you want the protection a trust can provide for a beneficiary but don't want to incur potentially a doubled income tax rate.

This increase applies to tax years beginning after December 31, 2021. This suggests for high income taxpayers realizing income in the current year before this additional change may be worthwhile. Income earned this year will be taxed at 35% instead of 42.6%.

Modifications to AGI include a reduction for investment interest.

Sec. 138206 adding new Sec. 1A.

Increase in Capital Gains Rate

The Biden administration had proposed taxing capital gains at ordinary income rates for those taxpayers with adjusted gross income of $1 million or more. That would have meant a tax rate of 39.6%. So, while the House proposal would increase capital gains rates, the change is not as costly as that initially proposed. Capital gains rate will be increased from 20% to 25%. This results in a 25% increase from the prior rate.

This change applies to taxable years ending after the date of introduction of this Act. The current capital gains tax rate of 20% will apply to gains prior to the date of introduction. It may also apply to sales that occur at a later date but based on a legally binding contractual arrangement that was in existence before the date of introduction. So, if you contracted to sell your business in March 2021 and it closes in November 2021, that should be subject to a 20% rate. But final legislative language (if this change is enacted) should be reviewed to confirm how this transition rule actually applies. What is the date of introduction? That is not the date of enactment. Could that potentially mean September 13, 2021, when the House Ways and Means Committee released their proposals? This is an important example of an effective date prior to 2022. But this effective date possibly means you can no longer trigger capital gains at the favorable old rate. So, continued planning for lower capital gains rates may no longer be possible.

Sec. 138202 changing Sec. l(h)(l)(D).

Net Investment Income Tax ("NIIT") Applies to Trade or Business Income

The NIIT tax had applied a 3.8% additional tax on certain investment income. The House proposal will substantial expanded this NIIT tax to apply to all business income for taxpayers with more than $500,000 of income on a joint return, $400,000 for a single individual. The NIIT tax is not assessed on earnings already subject to FICA tax.

The purpose of this change is to end a planning technique that many business owners had used. For example, a physician organized her practice as a S corporation. She earned profits of $1 million. She took $200,000 out as a salary subject to FICA tax and the remaining $800,000 she withdrew as S corporation distributions and avoided FICA Tax. Now, the $600,000 of profits over $400,000 will be subject to the 3.8% NIIT tax. Thus, the 3.8% tax will apply to distributions from S corporations, LLCs, and partnerships. This will eliminate the planning approach used by many of paying distributions from the pass through entity in lieu of higher salary. This change will eliminate the benefit that using an S corporation structure provided for some. So, some taxpayers may reassess the legal structure of their business entities if these changes are enacted. Since S corporations require special provisions in trust instruments (as only certain types of trusts are allowed to hold S corporation stock) those special provisions may no longer be necessary.

If there are buy sell agreements, valuations for buy out or other purposes, they may all have to be reassessed. For example, if the physician in the above example had a buyout agreement with her partner, she may have a formula for the buyout price pegged to profits. But if salary is now increased because there is no longer a benefit to making distributions instead of paying compensation,

that formula may be affected. Addressing this will be important for estate planning purposes.

The change is to apply to tax years after December 31, 2021. This might suggest to some that the planning illustrated above remains viable until year end. While that may be the case, such planning is not assured as the IRS may still challenge the above on the basis of the taxpayer/owner not being paid sufficient or “reasonable” compensation.

Sec. 138203 changing Sec. 1411.

Section 199A Deduction of Qualified Business Income Restricted

This provision, enacted as part of the 2017 tax act (the Tax Cut and Jobs Act), provided a deduction of 20% of income for qualifying business income (“QBI”). That specifically excluded income earned by specified businesses such as law, medicine and others. There has been a perception that this provision provided a significant benefit to many high income business owners so that the proposal restricts that. The maximum deduction that will be permitted will be $500,000 for those filing a joint (married) income tax return and $400,000 for single taxpayers. Notably, for trusts and estates the maximum deduction is set at a mere $10,000.

This will substantially limit 199A deductions for wealthy taxpayers. The figure for trusts is incredibly harsh and will effectively eliminate the benefit for trust owned real estate and other trust owned qualifying business interests. Now you have to consider what happens when evaluating gifts to trusts of real estate rental or other business interests that would qualify for 199A deduction for qualified business income as those interests will now be subject to the severe $10,000 limitation.

This change will apply to tax years beginning after December 31, 2021.

Sec. 138204 modifying Sec. 199A.

Restrictions on Use of Business Losses

Under current law the tax code limits pass-through business net losses which can offset non-business income to $250,000 (or $500,000 for married taxpayers filing joint returns). This change, if enacted, will permanently disallow net business deductions in excess of business income for non-corporate taxpayers. You will still be able to carry losses that are disallowed to the next tax year. Thus, you will no longer be able to offset losses on one business by other losses/gains on another business.

This change will apply to tax years beginning after December 31, 2021.

Sec. 138205 amending Sec. 461(1)

Contribution Limit for Individual Retirement Plans of High-Income Taxpayers with Large Account Balances.

If your retirement plan balances exceed $10 million, and your income exceeds $450,000 (married filing jointly) you will be restricted on making contributions to regular IRAs, Roth IRAs and defined contribution plans. Also, if you have such large account balances you will be required to withdraw from your plans pursuant to new minimum distribution rules.

Sec. 138301 and 138302.

New Prohibited Investments for Retirement Plans

The House proposal would prohibit an IRA from holding investments which are only offered to accredited investors (i.e., nonregistered securities). This is intended to prohibit investments that taxpayers have used to accumulate huge sums in their retirement accounts. IRAs holding such assets after the effective date would be deemed to be distributed. A 2-year transition period is provided.

The effective date would be after the end of 2021.

IRA Self-Dealing

Under current law, an IRA cannot invest in a business entity in which the IRA owner holds a 50% or greater interest. The House proposal will reduce this threshold to 10% for investments which are not tradable on an established securities market.

Reduction in Unified Credit

The amount of wealth that can presently be transferred without any gift, estate or generation skipping transfer tax is $11.7 million. The 2017 tax act had doubled the Basic Exclusion Amount (exemption or unified credit) and GST exemption from 2018-2025 from $5 million to $10 million, inflation adjusted from 2011. The Sanders proposal had provided for a $1 million gift tax exemption and a $3.5 million exemption for estate and GST tax purposes. The House proposal accelerates the 2026 reduction to 2022 and reduces the amount to $5 million inflation adjusted which might be about $6.2 million in 2022.

This House proposal thus terminates the temporary increase in the unified credit enacted as part of the 2017 tax act. That reduction was scheduled to occur in 2026 even if no change was made. Thus, it appears that the House

Democrats may have believe that this had better optics in terms of passage than the harsher Sanders proposal as, after all, this is the eventual exemption that was provided for under the President Trump 2017 law.

Taxpayers should act immediately to endeavor to use exemption before it declines by half. For example, if a single taxpayer makes a gift of $5 million to an irrevocable trust now, and the exemption declines to $6.2 million next year, they will have done nothing to salvage any of the exemption that will be lost. So, for some wealthy taxpayers that have not yet used their exemption, planning might entail on an urgent basis (not just before end of year) using as much exemption as is appropriate. "Appropriate" requires considering of your budget and cash flow needs, sources of income and other cash inflows and the nature of the trusts. If you create a self-settled trust in a state that permits such trusts (there are now 19) that means you are a discretionary beneficiary of the trust. That might make it feasible for you to gift more assets to a trust now. Be certain to evaluate the additional risks that a self-settled trust might add to your planning, especially if you live in a state that does not permit such trusts. There are also other variations of trust planning (e.g., hybrid-DAPT, special power of appointment trust, etc.) that you might consider. Married taxpayers could create a trust of which their spouse is a beneficiary, so-called spousal lifetime access trust ("SLAT"). If you create such a trust, then you might indirectly benefit from distributions made to your spouse. But SLATs are not an assured solution to every issue. Divorce or premature death could shut off your access to such a trust creating financial issues for you. So, the decision is complicated and requires consideration for most taxpayers of several factors. As discussed below, this may be the last opportunity to create traditional SLATs as post enactment, only spousal lifetime access non-grantor trusts ("SLANTs") may be feasible. Those will involve additional complications.

However, the effective date of this will be critical to the potential for any additional planning to succeed. This provision is effective January 1, 2022. However, other critical provisions to estate planning, such as the rules affecting grantor trusts discussed below, are effective the date of enactment. That means that for most planning that taxpayers will desire to pursue, the real effective date is not year-end, but date of enactment, which remains unknown.

Sec. 138207 modifying Sec. 2010(c)(3) and 2631(c).

Valuation Reduction for Certain Real Property Used in Farming or Other Businesses

This is one of the few taxpayer friendly provisions and it comes out of the continuing perception that family farms particularly deserve special protection from the impact of the estate tax. How many farms might really benefit may be much less than most people would expect, but this continues to have political clout.

The tax laws presently provide for special valuation rules for real property used in farms and certain other qualifying business endeavors. These rules permit you to value farm property based on its current use as farming property. This is an exception from the general rule that property has to be valued at its highest and best use. So, for example, if you have farm property but the farm could be redeveloped into a subdivision for houses which would be much more valuable, the lower farming value can be used. A drawback to this provision had been that the maximum reduction was $750,000. The new law will increase this to $11,700,000.

This may be a significant benefit to family farms and businesses. If there are no capital gains taxes on death (as noted above deemed realization has not been included in the House proposal but there is no assurance that it might not be added in the Senate), and if the step-up in income tax basis on death remains part of the law, it might make sense to evaluate what should be done with farm and qualifying business real estate. This provision might make it advantageous to retain such real property in the estate rather than use the current temporary exemption before it declines. Further, if the farming or other business owning qualifying property presently qualifies for the 199A 20% deduction for qualified business income and contributing it to a trust to use exemption would subject that business to a maximum $10,000 199A deduction. Retaining that business, or at least the real property component, in the estate may provide in some instances a better tax result.

Sec. 138208 modifying Sec. 2032A.

Restrictions on Grantor Trusts

A “grantor” trust is a trust which, for income tax purposes, the income is taxed to the settlor or person creating the trust. Under current law taxpayers can have their trust tax cake and eat it too. You can have a trust which is taxed to you for income tax purposes, and which thus provides you a host of planning benefits. Yet, that same trust can be outside of your estate when you die and thus provide significant estate tax planning benefits as well. The new rule provides that any grantor trust that is created on or after the date of enactment will be included in your estate. For grantor trusts that were created before the date of enactment they may avoid estate tax inclusion by being subject to current law (“grandfathered”). However, if you make a gift to a

grandfathered grantor trust a portion of that trust will then be included in your estate.

One particularly valuable planning use of grantor trusts was for a wealthy taxpayer to create a grantor trust and then sell assets to that trust. No gain would be recognized for income tax purposes because a grantor trust was ignored for income tax purposes. This permitted tremendous wealth shifts outside of the taxpayer's estate. For example, if you have a family business that was valued at $10 million you could restructure the business into voting and non-voting interests and sell 99% non-voting interests to the trust for a note. The non-voting interests would be valued under current law at a discount for valuation purposes as they were a non-controlling equity interest. So, the value of the interest might be $6.5 million. That business interest could then grow in the grantor trust outside your estate shifting even further wealth outside the tax system. This type of planning was specifically targeted with several changes. First, if you sell assets to a grantor trust after the date of enactment income tax will be triggered. That would eliminate the use of this technique if the assets involved have appreciated. In many cases, taxpayers will not be willing to incur a current income tax, especially at the new higher capital gains and surtax rates, to shift wealth outside their estate. Note that the combination of all of these income tax increases could make the income tax cost on a sale of appreciated assets higher than the current estate tax rate. Secondly, if there is a valuation challenge by the IRS and the IRS proves that the value of the asset sold to the trust was higher than you anticipated, that would trigger an additional gift to the trust and estate inclusion. Finally, as discussed in the provision below, discounts might be reduced thereby reducing the leverage achievable on such a sale transaction.

Grantor retained annuity trusts ("GRATs") are not expressly mentioned in the House proposals but seem to be eliminated by the above changes. First, any new grantor trust created after the date of enactment will be fully included in the taxpayer's estate. Thus, if you create a GRAT to leverage wealth out of your estate after enactment of the new legislation, the entirety of the GRAT will be included in your estate if you die during the GRAT term. Under current law only a portion of the GRAT assets will assuredly be included in your estate (determined by dividing the GRAT annuity payment by the mandated federal interest rate under Sec. 7520 in the year of death). Also, distributions from grantor trusts during your life as the deemed owner of the trust for income tax purposes are taxable gifts. Finally, the assets of a grantor trust are deemed to be a gift if the grantor trust income tax status is "turned off" (e.g., by your relinquishing the right to substitute trust assets). Thus, it appears that the GRAT technique will be gone. What does that mean now? It means that this may be the last opportunity to complete GRATs if they will benefit your planning. If you have not used all of your exemption an outright gift to an irrevocable trust before enactment of the new law might be better planning to safeguard your exemption. If you have used all of your exemption, then GRATs might provide a valuable technique to leverage additional wealth out of your estate without triggering current gift tax costs (since GRATs can be "zeroed out" with no current gift value). You might consider a different type of GRAT if their demise is imminent. Perhaps a ladder of GRATs (e.g., a 4, 6, 8 and 12 year GRAT instead of the traditional 2-year GRAT) might be advantageous to lock in the GRAT technique and current historically low interest rates.

Qualified personal residence trusts ("QPRTs") special trusts intended to hold houses appear also to be eliminated post enactment for the same reasons that GRATs appear to be eliminated. It would seem that if the intent is to eliminate

GRATs and QPRTs that might be more expressly addressed in any final legislation.

Qualified Subchapter S Trust ("QSSTs") have income taxed to the beneficiary. Will these trusts if created post-enactment be included in the beneficiary's estate?

These changes apply to grantor trusts created after the date of enactment and to gifts made to grantor trusts after the date of enactment. This effective date has critical implications to current planning. If you want to use some of your remaining temporary gift and GST exemption in many perhaps most cases making gifts to a grantor trust may be your better option. If you make gifts to heirs outright those gifts will be exposed to the heirs creditors, divorce and irresponsibility. You can make gifts to benefit the same people in the protective structure of a trust. Thus, the real deadline for using exemption is not the end of the year, but rather date of enactment.

Sec. 138209 adding new Sec. 2901 and new Sec. 1062.

Grantor Trust Changes Impact on Life Insurance Planning

One of the most common irrevocable trusts used in estate planning has been the irrevocable life insurance trust ("ILIT"). These will be undermined by the House proposal if enacted as most traditional ILITs have been structured to be grantor trusts. For new ILITs that will not be feasible as it will assure inclusion in your estate. Instead, new ILITs may have to be structured as non-grantor trusts to avoid estate inclusion. That, however, will present a raft of problems. First, that will require that the trust expressly prohibit trust income being used to pay for life insurance premiums on your life as the settlor of the trust. Second, for existing grandfathered trusts no new gifts should be made to the

ILIT or a portion of the trust assets (i.e., insurance proceeds) will also be included in your estate. Thus, future premium needs will have to be addressed with loans to the trust. That will also raise other issues, such as whether the IRS will respect the transactions as loans. A series of examples will illustrate some of these points in context of the House proposal.

Taxpayer is a single working mom with five young children. She is young, not particularly wealthy, and in great health. Taxpayer purchases a $5 million 20-year term life insurance policy to make certain each of her five children are well provided for if she dies before they reach adulthood. Under current law, if Taxpayer dies no estate tax will be due unless her other non-insurance assets exceed $6.7 million (since the exemption, the amount you can bequeath without tax, is $11.7 million). If the House tax proposal is enacted before Taxpayer dies, that could reduce the exemption to $5 million inflation adjusted to $6.2 million. Then a substantial portion of the life insurance the Taxpayer hopes will protect her children could be consumed by federal estate taxes.

The simple answer for the Taxpayer in the above example is to create a trust to own her life insurance policy. Properly done, under current law, that could avoid all estate taxes on the proceeds. That type of trust is the ILIT discussed above. But does she really need to divert her attention now to create a trust for her insurance now? Yes. The House proposal would make the grantor trust changes effective date of enactment. That would have costly adverse consequences for a working parent trying to protect their children or anyone else wishing to engage in insurance planning post enactment.

Taxpayer has a life insurance policy in her name and wishes to transfer it to an ILIT to remove it from her taxable estate. If she gifts the policy to a trust, it

will still be included in her estate if she dies within three years of the gift. However, if instead she sells the policy to the ILIT, the insurance proceeds will be outside her taxable estate even if she dies the next day.

But the House proposals would prevent this post enactment in many cases. A taxpayer can sell a life insurance policy that may otherwise generate gain to a grantor trust. But post enactment that will be pointless as assets of a new grantor trust will be included in the Taxpayer's estate. If instead the new ILIT is structured as a non-grantor trust it may be excluded from the Taxpayer's estate, but the sale of a policy to a non-grantor trust may trigger gain.

Valuation Rules for Nonbusiness Assets

Under current law you might transfer a marketable securities portfolio into a family limited partnership ("FLP") or a family limited liability company ("LLC") and then gift or sale non-controlling fractional interests to various trusts. When that is done the value of the non-controlling entity interest might be reduced by 15-35% or more depending on the facts, type of assets, and opinion of the qualified appraiser. That discount has been a common component of estate tax minimization planning. The IRS has long sought to restrict the use of discounts, especially on non-business assets, and Congress appears to be on board. There clearly was concern that valuation discounts in the context of cash and marketable securities, while supported by valuation theory, may not be an appropriate component of the estate tax system. The House proposal provides that there will not be any valuation discount permitted for transfer of non-business assets. Non-business assets include passive assets held for the production of income such as cash, marketable securities, triple net leased real estate and other assets not used in the active conduct of a business. Several of these terms raise definitional issues as to

what is included, or not. At what point does real estate become characterized as a passive investment asset versus an active business? How does one demarcate working capital necessary to the operation of an active business versus an investment portfolio merely held in the entity solution? To minimize planning machinations these new rules on valuation discount restrictions include look-through rules that requires treating an entity as owning pro-rata the underlying asset of an entity in which it owns a 10% or greater interest.

This will eliminate the use of FLPs and LLCS for discounting marketable securities and perhaps other assets. For taxpayers who may benefit from discount planning that will be eliminated or restricted, planning should proceed on an urgent basis. As discussed for several provisions above, if the assets involved will be transferred not to heirs outright but to grantor trusts, those transfers should be completed before the date on which the new law is enacted.

Sec. 138210 modifying Sec. 2031.

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