Recycled Proposals Make their Return as President Biden Releases Proposed 2025 Budget

On Monday, March 11, the Treasury released its general explanations of the Biden Administration's $6.9 trillion budget for fiscal year 2025, known as the Greenbook. Its nearly 100 revenue proposals include ones similar to the 2024 budget proposals. Most of the revenue provisions were also part of the White House's Build Back Better plan for the Fiscal Year 2022 Budget and represent Biden's tax platform for the Presidential election campaign and the Democrats' tax agenda for 2025 and beyond. As such, they should be taken as indicators of the Administration's legislative priorities should President Biden win another term as president and Democrats take full control of Congress this November.

Here are highlights of select provisions that would affect matters close to our industry, including estates, trusts, and higher individual income earners:

Estate and Trust Planning Proposals

Limit Annual Exclusion Gifts

The proposal would limit the tax-free transfer of annual gifts whether to individuals or in trust and certain outright gifts of business interests to a total amount of $50,000 per year, indexed for inflation after 2025, even if the total gifts to each individual did not exceed the 2024 gift tax annual exclusion of $18,000.

The proposal would be effective for gifts made after December 31, 2024.

Transfers of Appreciated Property

Under current law, there is generally a carryover basis for gifts and a basis step-up for transfers at death. The Administration proposes to treat transfers of appreciated property by gift or on death as income-taxable events. Any tax on capital appreciation at death would be a deductible expense of the decedent's estate – not a credit against estate tax – and the use of capital losses and carry-forwards from transfers at death would be allowed against capital gains and up to $3,000 of ordinary income on the decedent's final income tax return.

To capture appreciation on assets held by entities rather than individuals, the Administration also proposes to tax gain on unrealized appreciation in a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. This provision would apply to property held on or after January 1, 1944, that is not subject to a recognition event after December 31, 1943, so that the first recognition event would be deemed to occur on December 31, 2033.

Transfers to a U.S. spouse would receive a carryover basis, and transfers to charity would not be taxable; however, transfers to a charitable lead trust or charitable remainder trust) would be taxable except to the extent of the value of the charity's interest. The current exclusion for gain on the sale of a principal residence would continue to apply, and tangible personal property excepting collectibles would be excluded. A $5 million per person exclusion on property transferred by gift or at death would apply, indexed for inflation after 2024, and the exclusion would be portable between spouses. Tax on certain family owned and operated businesses would be deferred until the interest is sold or the business ceases to be family owned and operated, and any tax on appreciated assets other than liquid assets could be paid over 15 years, subject to the IRS's underpayment rate in effect at the time of the event.

These changes would be effective for gifts after December 31, 2024, for persons dying after December 31, 2024, and for property owned by trusts and partnerships on January 1, 2025.

Valuation Discounts

Taxpayers are often able to take advantage of discounts for lack of control and lack of marketability when transferring interest in closely held entities, real estate, and other personal property. The proposed budget would require that intrafamily transfers of partial interest in property in which the family collectively owns at least 25% be valued based on the interest's pro rata share of the collective fair market value of the interests held by the taxpayer and the transferor's family members.

In the case of an interest in a trade or business, the passive assets would be valued separately from the trade or business assets.

This provision would apply to valuations as of a valuation date on or after the date of enactment and be effective for taxes for which the three-year window would end after December 31, 2024.

Changes to Treatment of Grantor Trusts

In the world of tax planning the term "grantor trust" refers to trusts whose settlor (or grantor) is the designated taxpayer for all items of income earned from trust assets. Many grantor trusts are also designed to be "intentionally defective." This simply means that for purpose of income taxes the grantor is still treated as the owner of the assets, but not for estate tax purposes. This type of tax treatment has several advantages, some of which the current proposed legislation would remove. Under the proposed budget, the following would apply:

- **Trust income taxes subject to gift tax treatment:** To the extent a trust grantor personally recognizes trust income, pays the tax owed, and is not reimbursed by the trustee, the tax payments are treated as gifts to the trust beneficiaries. The amount of the gift cannot be reduced by a marital or charitable deduction or by the exclusion for present interest gifts or gifts made for the donee's tuition or medical care.
- **Disregarded sales:** Asset sales to irrevocable grantor trusts would no longer be disregarded for capital gains tax purposes, effectively ending the "estate freeze" technique of selling appreciating assets to an intentionally defective grantor trust (IDGT) in exchange for a promissory note.
- **Transfers of appreciated property:** Transfers of property into a trust that is wholly owned and revocable by the grantor would not be a recognition event for appreciated property. The deemed owner of such a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

As with changes to valuation discounts, the new grantor trust rules would take effect on the date of the law's enactment. The gain recognition portion would apply to all transactions between a grantor trust and its deemed owner occurring on or after the date of enactment.

Grantor-Retained Annuity Trusts (GRATs)

The budget proposal would impose a minimum GRAT term of ten years and a maximum term no greater than ten years following the death of the annuitant. It would also require a beneficial remainder (gift amount) equal to the greater of $500,000 or 25% of the trust's fair market value at inception, but not more than the value of the assets transferred. In addition, annuity payments could not decrease over the term of the GRAT, and the grantor could not exchange GRAT assets for assets of equivalent value without recognizing gain or loss for tax purposes..

The changes would apply to GRATs created on or after the date of enactment.

Limit Duration of "Dynasty" Generation-Skip Trusts

Many states have repealed or substantially modified their rule against perpetuities as it applies to trusts. In consequence, assets in a generation-skipping transfer tax (GSTT) exempt trust can avoid federal transfer taxes for much longer than the traditional "life + 21" rule, in some cases for hundreds of years or even in perpetuity.

The administration proposes that the GST exemption would only apply to (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust, and (b) taxable terminations occurring while any person described above is a beneficiary. The provisions resetting the transferor upon the payment of GST tax would not apply, and existing trusts would be treated as having been created on the date of enactment.

Modify the Definition of a Guaranteed Annuity from a Charitable Lead Annuity Trust (CLAT)

The proposal would require that the annuity payments made to charitable beneficiaries of a CLAT at least annually must be a level, fixed amount over the term of the CLAT, and that the value of the remainder interest at the creation of the CLAT must be at least 10 percent of the value of the property used to fund the CLAT, thereby ensuring a taxable gift on creation of the CLAT.

The proposal would apply to all CLATs created after the date of enactment.

Retirement and Income Planning Proposals

Increase the Top Marginal Income Tax Rate for High Income Taxpayers

The top income tax rate is presently 37%, scheduled to revert to 39.6% in 2026. In 2024 this rate applies to taxable income over $609,350 (single filers), $731,200 (joint filers), and $15,200 (trusts and estates).

The Administration proposes to increase the top rate to 39.6% beginning in 2024. The top rate would apply to taxable income over $400,000 (single) or $450,000 (joint) in 2024 and would be indexed after 2024. No change to the top income bracket for trusts and estates is specified in the Treasury's general explanations.

Tax Rate on Qualified Dividends and Long-Term Capital Gains

The top income tax rate on qualified dividends and long-term capital gains is presently 20%. The Administration proposes to tax qualified dividends and long-term capital gains at ordinary income rates, with a top rate of 37% (or 39.6% if the top rate is increased), for taxpayers with income over $1 million, but only to the extent the taxpayer's income exceeds $1 million ($500,000 for married filing separately), indexed after 2024. This proposal would be effective as of the date of enactment.

Limit Tax Benefits for Private Placement Life Insurance

The proposal would limit the tax benefits for private placement life insurance and annuity contracts. It would do so by defining a class of contracts ("Covered Contracts") that are predominantly investment oriented and subjecting them to the following tax consequences:

- Loans, withdrawals, death benefits, and amounts subject to assignment to a third party would be taxed as ordinary income to the extent the payment or assignment exceeds the policy's cost basis. The net amount at risk payable in a death claim would be excluded from this treatment.
- An additional tax equal to 10% of any taxable distribution would be assessed, but not in addition to any 10% additional tax assessed if the policy is also a Modified Endowment Contract.
- The policy's cost basis would be reduced by the amount of mortality charges that have been assessed against the contract fund.

Minimum Tax on Wealthiest Taxpayers

At present, gains are not taxable until realized and recognized, most often as the result of the sale of property. The Administration proposes to impose a minimum tax of 25% on total income, including unrealized capital gains, on taxpayers with wealth of over $100 million, even if no sale of property occurs.

This change would be effective beginning in 2025.

Special Distribution Rules on High Income Taxpayers with Large Retirement Account Balances

High income taxpayers with large retirement account balances would face special distribution rules. A high-income taxpayer with vested account balances over $10 million as of the last day of the previous year would have to distribute at least 50% of the excess. In addition, if the vested account balances exceeded $20 million, the taxpayer would have to distribute the lesser of the excess above $20 million or the amount held in Roth IRAs or designated Roth accounts.

For purposes of the change, a high income taxpayer is one with modified adjusted gross income over $400,000 (single) or $450,000 (joint).

The taxpayer may choose the source of the distributions, except that if the vested balances are over $20 million, the additional distributions must come first from Roth IRAs and then from designated Roth accounts. The change would be effective for taxable years beginning after December 31, 2024.

The distribution required under the proposal is structured as an increase to the RMD for purposes of the excise tax on failure to take RMDs. As a result, a taxpayer who fails to satisfy the requirement is subject to a 25 percent excise tax on the portion of the distribution not taken (reduced to 10 percent if the failure is corrected within a specified period). The requirement to take this minimum distribution applies without regard to whether an RMD otherwise must be taken by the taxpayer in the year.

Limit Rollovers and Conversions to Designated Roth Accounts or Roth IRAs

This provision would prohibit a high-income taxpayer from rolling over to a Roth IRA an amount distributed from a traditional IRA or an eligible retirement plan other than a designated Roth account.

It would also prohibit a high-income taxpayer from rolling over amounts distributed from a traditional IRA or an employer plan other than a designated Roth account into a Roth IRA or a designated Roth account if any part of the distribution includes a distribution of after-tax contributions (other than contributions to a designated Roth account).

These rules would eliminate Roth conversions and "back-door" Roth conversions for high-income taxpayers.

For this purpose, a high-income taxpayer is one with modified adjusted gross income over $400,000 (single) or $450,000 (joint).

This change would be effective for distributions made after December 31, 2024.

Expansion of Tax on Net Investment Income (NIIT)

Individuals with modified adjusted gross incomes over a threshold amount are subject to a 3.8% tax on The Administration proposes to amend the definition of net investment income to include gross income and gain from any trade or business of an individual that is not otherwise subject to employment taxes. It would include all nonwage earnings of high income S corporation owner-employees, and it would include sales of business property by active partners and S corporation shareholders.

All of the revenue from the net investment income tax, both that raised under current law and that raised by the proposed expansion, would be directed to the Medicare trust fund, just as is the revenue from the Medicare portion of FICA and the self-employment tax. Owners providing services who materially participate in the trade or business would be subject to SECA taxes on their distributive shares of partnership, LLC or S corporation income.

This proposal would be effective beginning in 2024.

Increased Tax Rate on Net Investment Income (NIIT) for Certain Taxpayers

Net investment income is generally subject to the 3.8% tax on net investment income. The proposed budget would address projected Medicare shortfalls by increasing the tax rate by 1.2 percentage points to 5.0% for taxpayers with more than $400,000 of earnings, indexed for inflation.

The proposal would be effective beginning in 2024.

Conclusion

Like President Biden's 2024 budget proposal, this one was delivered to a Republican-controlled House of Representatives, prompting some commentators to doubt its overall viability. However, as noted above, it contained over 80 different revenue proposals, and this article has covered only a few of them. No one can say how budget negotiations may actually play out; even if only a portion of the current proposals become law, there could be significant impacts on clients' planning now and far into the future. The proposals with the broadest impact would be the increase in the personal income tax rate and the forced gain realization on property transferred by gift or at death.

The forced gain realization on gratuitous property transfers would provide a $5,000,000 (as adjusted for inflation) exclusion from the imposition of capital gains taxes on transfers during lifetime or at death, and transfers to charity or a spouse would not be subject to these rules. It would also have an effective date of January 1, 2025, so there is still time to act for those considering lifetime transfers.

The most straightforward action wealthier clients can take now is to work with their tax and legal advisors to explore making maximum gifts before the end of the 2024. Married couples can give up to $27,220,000 between them this year.

If you have an estate planning opportunity in these uncertain times, Prudential's Advanced Planning team is here to help. We can be reached at 800-800-2738, Option 4.

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