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Tax Changes for Estates and Trusts in the Build Back Better Act (BBBA)

The Build Back Better Act (BBBA; H.R. 5376) would revise the estate and gift tax and treatment of trusts. It would eliminate the temporary increase in exemptions enacted in the Tax Cuts and Jobs Act (TCJA; P.L. 115-97), increase the limits on certain discounts of value for businesses to reflect use rather than market value, eliminate minority discounts for cash and readily marketable securities, and revise the rules for grantor trusts.

Changes in the Estate and Gift Tax Exemption

The estate and gift tax applies on a unified basis on lifetime gifts plus the estate at a 40% rate after deducting an exemption. The taxable estate is transfers (i.e., the estate plus lifetime gifts) minus transfers to a spouse, charitable transfers, certain estate tax costs, and the exemption. (A separate annual gift exclusion for each donee is set at $15,000 in 2021.) The estate tax exemption was set at $5 million in 2011, adjusted for inflation. The TCJA doubled that exemption for 2018-2025; with inflation adjustments, the exemption is $11.7 million in 2021. The surviving spouse inherits any unused exemption, which simplifies the choice of leaving estates to the surviving spouse, because it preserves the exemption for future beneficiaries.

The BBBA would restore the exemption to pre-TCJA levels for 2022 and after, reducing the current exemption by half for 2022-2025. The Joint Committee on Taxation (JCT) estimates this provision to raise $54.3 billion for FY2022-FY2031. Most of the revenue gain would be in the first five fiscal years because the exemption is scheduled to revert to the lower level after 2025.

Increasing the Dollar Limit on Discounts for Businesses Reflecting Value in Use

The tax code allows businesses to value their assets at use as a farm or business rather than market value. This provision is particularly beneficial to farms and allows a reduction in the estate value of up to $1 million, adjusted for inflation ($1.19 million in 2021). It means, for example, that the value of the farm will be what it could be sold for if restricted to farm use rather than to be subdivided for development. Heirs are required to continue use of the assets as a farm or business for 10 years.

The proposal would increase the dollar limit on the reduction to $11.7 million. The JCT estimates this provision to cost $0.3 billion for FY2022-FY2031.

Minority Discounts

Whereas cash and readily marketable securities can be easily valued for estate tax purpose, assets held in private companies are more difficult to value. Estates can claim minority discounts when an heir receives a minority share in a company, and courts often allow significant discounts, even if disputed by the Internal Revenue Service. The rationale is that the individual does not have a controlling interest, which reduces the value of the assets. One practice used to reduce estate tax value is to transfer cash and marketable securities to a family firm with the heirs each receiving a minority share, leading to a discount on these amounts as well as the value of business assets.

The BBBA would disallow discounts for cash and readily marketable securities contained in a private corporation or partnership. Exceptions exist, however, for assets used for hedging transactions and for working capital. The remaining assets would be valued under the standard rules (i.e., the price paid between a willing buyer and a willing seller).

The JCT estimates this provision to raise $19.9 billion for FY2022-FY2031.

Grantor Trusts

In a grantor trust, the income tax system treats an individual as owner. However, the estate and gift tax treats the trust and the individual as separate persons. Grantor trusts can be used to transfer assets out of the individual's estate.

For income tax purposes, the grantor and the trust are treated as a unit, so that transactions between them are disregarded. Grantor trusts can be designed so that the earnings of the trust flow through to the grantor and the grantor pays the income taxes. Because these taxes are not considered gifts to the trust, the earnings in the trust can grow tax free.

For estate and gift tax purposes, the trust's assets are separate from the individual so that distributions to beneficiaries are not treated as gifts under the gift tax and the trust's assets are not included in the estate. One technique to transfer assets into the trust is to sell an appreciated asset to the trust in exchange for a low-interest promissory note. No capital gain will be realized on the transfer and no income tax paid on the interest payments. A grantor may also swap assets of equal value, which can be beneficial for tax purposes if high-basis assets (which would yield lower capital gains if sold by the trust to a third party) are exchanged for low-basis assets, which will not be subject to capital gains tax at death.

The BBBA would treat the transfer of property between the grantor and the trust as a taxable event, so that gain would be recognized on transactions (losses would not be recognized). The revision would also include the trust in the taxable estate and any distributions made by the trust to the beneficiaries would be treated as a gift made by the grantor and thus subject to gift tax rules. This provision would apply to grantor trusts other than revocable trusts (revocable trusts are included in the estate) but would be grandfathered, so that only contributions and transactions with the trust going forward would be covered and included in the estate.

These provisions would apply to all irrevocable grantor trusts, including Grantor Retained Annuity Trusts, insurance trusts, and spousal lifetime access trusts (i.e., trusts allowing lifetime benefits for spouses).

The JCT estimates these provisions to raise $7.9 billion for FY2022-FY2031.

Not Included: Taxation of Gains at Death

Unrealized capital gains passed on at death are never subject to tax because the heir takes the basis (the amount deducted on sale) as the value at time of death. This provision is called stepped-up basis. The Biden Administration proposals included a provision to tax capital gains at death. The BBBA did not include a provision to tax capital gains at death or to impose a carryover basis in which the heir takes the basis of the decedent.

For background on the estate tax, see CRS Report R42959, *Recent Changes in the Estate and Gift Tax Provisions*, by Jane G. Gravelle. For background on the treatment of capital gains at death, see CRS In Focus IF11812, *Tax Treatment of Capital Gains at Death*, by Jane G. Gravelle.

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