



Business Transition Advisory Services

The Rough Seas of Tax Reform Uncertainty

November 22, 2021

Are any of the proposed tax law changes happening? Is there anything I should be doing now to prepare my family and my business? These questions are on the minds of many business owners right now. And, although the answer to the first question currently remains unclear, for most business owners it is still a great time to begin (or to continue) implementing planning strategies to help protect the legacy they have built.

The sheer volume of tax reform proposals this year has created some choppy water from a planning perspective. Although Democrats currently hold a small majority in both houses of Congress, they have struggled to reach consensus on their spending and tax reform proposals. The following is a brief summary of their efforts so far this year.



Early 2021

Proposals presented during this time, including President Joe Biden's American Families Plan and Senator Bernie Sanders' For the 99.5% Act, would have made the following changes:

- ✓ **The top capital gain tax rate** would have increased from 20% to 39.6%.
- ✓ **A gift of an appreciated asset**, whether made during lifetime or at death, would have triggered the realization of capital gain as if the asset had been sold.
- ✓ **The estate and gift tax rate would have increased** from 40% to as high as 65% for larger estates, and the exemption amount would have decreased from \$11.7 million per person to approximately \$6 million per person beginning on January 1, 2022.¹

¹ Additionally, only \$1 million of the exemption amount would have been available to be used for lifetime gifting.



September 13, 2021

The House Ways and Means Committee released a summary of updated tax increase and revenue-raising proposals to fund House Democrats' \$3.5 trillion spending plan (also known as the Build Back Better Act or budget reconciliation bill, H.R. 5376). This update included a combination of old and new proposals, and would have made the following changes:

- ✓ **The top capital gain tax rate** would have increased from 20% to 25% as of September 13, 2021.²
- ✓ **Beginning in 2022**, there also would have been a new 3% surcharge tax on adjusted gross income over \$5 million.
- ✓ **The estate and gift tax exemption amount** would have decreased from \$11.7 million per person to approximately \$6 million per person beginning January 1, 2022.
- ✓ **Grantor trusts** would no longer have been viable estate tax planning techniques.³

2. The proposal included a safe harbor that would apply the existing top 20% rate to any capital gain recognized between September 13, 2021 and December 31, 2021, if the gain arose out of a written binding contract that was entered into on or before September 13, 2021 and was not subsequently modified in any material respect.

3. Today, many common estate tax planning techniques, including Intentionally Defective Grantor Trusts (IDGTs), Spousal Lifetime Access Trusts (SLATs), and Grantor Retained Annuity Trusts (GRATs), are built using the framework of an irrevocable "grantor trust," which is designed to take advantage of a mismatch between current income tax and gift tax rules.





October 28, 2021 to Present

In late October, President Biden and the House Rules Committee released a slimmed-down version of the Build Back Better Act, which eventually passed in the House of Representatives on November 19, 2021. Notably absent from the latest version of the legislation is any change to the capital gain tax rate, the gift and estate tax exemption amount, or the grantor trust rules. Instead, this latest version will make the following changes if enacted into law:

- ✓ **A new surtax will be imposed on high-income taxpayers**, specifically a 5% surtax on modified adjusted gross income in excess of \$10 million and an additional 3% surtax on modified adjusted gross income in excess of \$25 million, effective January 1, 2022.
- ✓ **The 3.8% net investment income tax (NIIT) will be expanded** so that it applies to all income earned from a trade or business (not just passive income), a change that primarily will impact the owners of certain pass-through businesses such as S corporations and LLCs.⁴ This change also would be effective January 1, 2022.
- ✓ **The capital gain exclusion for qualified small business stock** (also known as 1202 stock) will be limited to 50% for taxpayers with adjusted gross income equal to or exceeding \$400,000, effective retroactively to any sale or exchange after September 13, 2021.⁵

4. Currently the net investment income tax generally only applies to investment income and passive income from a trade or business.

5. Current law allows for a 100% gain exclusion for certain qualified small business stock upon a sale. The proposal includes a safe harbor that would apply the existing rules (i.e., up to 100% exclusion) to any Section 1202 gain recognized after September 13, 2021, if the gain arose out of a written binding contract that was entered into on or before September 13, 2021 and was not subsequently modified in any material respect.

Even though the latest version seems to remove many of the proposals with the largest tax implications for business owners, there is still the possibility of further changes as the legislation moves through the Senate. And, even if no tax law changes happen this year, taking steps now to begin planning still makes sense for most business owners. For example, under current law, the gift and estate tax exemption amount is scheduled to be cut in half beginning in 2026. Our advice is to plan early, plan often, and do not wait to implement your plan until certainty is reached. By then, it may be too late to accomplish many of your goals.

Smoother Sailing Through Planning: A Case Study

Jane built her company from the ground up into a **successful enterprise**. Although it has been a struggle at times, especially in the early years, Jane thoroughly enjoys her work and is proud of the company's success. Nevertheless, she is beginning to feel it is time for a change. She wants to spend more time with her young grandchildren and finally tackling a lifelong dream of traveling to every continent around the world.

Jane talked to her commercial banker, who then introduced Jane to Fifth Third's Capital Markets and Business Transition Advisory Teams to begin **exploring her options**. As a result of that process, Jane is considering selling her company, but she decides she would first like to do some wealth transfer planning for the benefit of her family. Well in advance of the sale (and before obtaining a letter of intent from a potential buyer), Jane works with her estate planning attorney to hire a qualified business appraiser to provide an appraisal for estate and gifting purposes. The appraiser appraised the value of a minority, non-controlling ownership interest in the company (reflecting discounts for lack of control and lack of marketability).



Using this valuation, Jane decided to give 25% of her ownership interest in the company to an irrevocable trust she created for the benefit of her spouse, children, and grandchildren. Based on the qualified business appraisal, the 25% ownership interest had a value, after discounts, of \$11 million (absent the discounts, the ownership interest would have had a value of \$16 million). Through this gift, Jane was able to remove \$16 million in stock from her estate while only utilizing \$11 million of her exemption (and saving her estate a 40% transfer tax on that difference).



Jane then moved forward with a sale of the company and ultimately received a letter of intent from a buyer to purchase the entire company for \$70 million. After the sale is concluded, 25% of the proceeds (\$17.5 million) will flow into the irrevocable trust for the benefit of Jane's spouse, children, and grandchildren, effectively removing \$17.5 million from Jane's estate while only utilizing \$11 million of exemption.



Measured at the end of 2021, Jane's planning will have resulted in an estate tax savings of approximately \$2.6 million, and this amount could increase dramatically with time. Assuming the irrevocable trust is properly drafted and administered, any future growth in the value of its assets should not be subject to estate taxation at the time of Jane's death. So, for example, if the trust's assets appreciate at an effective annual rate of 5% per year, net of income taxes and fees, and Jane lives for another 30 years after the sale, the trust's assets would have a value of approximately \$61 million at the time of Jane's death. In that event, Jane's planning will have resulted in an estate tax savings of approximately \$26 million, an amount which could continue to grow and avoid further estate taxation during the lifetimes of her children and grandchildren.

Illustrations are for informational purposes only and do not depict actual planning strategies or results.

Please reach out to your Fifth Third Private Bank Advisor if you would like to discuss whether you might benefit from planning ahead in anticipation of any potential tax law reform.



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About Fifth Third's Business Transition Advisory Team

Fifth Third's Business Transition Advisory Team (BTAT) is a Private Bank Team solely dedicated to financially and personally preparing business owners for their business transition. With 75+ years of combined experience, BTAT provides deep education and expert advice across a diverse range of industry sectors.

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Please note, this information is subject to change and is not an exhaustive list of the potential tax law changes.

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