What You Need to Know to Avoid STEP-ing into an Unexpected Tax Result

The Biden administration's first major legislative accomplishment was the $1.9 trillion COVID-19 relief bill. Now attention is turning to a massive infrastructure and tax package. The White House is describing that effort in two stages. President Biden introduced "Infrastructure 1" on March 31, a $2 trillion package paired with substantial corporate tax increases.

On April 28, during an address to a joint session of Congress, the president introduced the framework for "Infrastructure 2," which the White House is calling the "American Jobs Plan." As expected, the plan called for universal preschool for 3 and 4 year olds, paid family leave, and two years of free community college, among many other provisions. The American Jobs Plan comes with a proposed $1.8T price tag, which is $1T in spending and $800B in tax credits. This will be paid for with proposed tax increases focused on individuals and small businesses, specifically a proposal to increase the maximum tax bracket to 39.6%, an increase of the capital gains tax rate to 39.6% for households making more than $1M, a $500,000 cap on Section 1031 exchanges, and $80B for the IRS to increase tax audits and collection efforts.

The two infrastructure proposals from the White House combined with other recent tax-overhaul bills is a lot for all of us to unpack. Before we get too far into the analysis of all this potential tax law change, it's important to remember that making law in this area will involve compromise between progressive and moderate democrats, and, ideally, Republicans. For example, Senate Republicans recently unveiled a counterproposal to President Biden's first infrastructure bill, offering their own infrastructure bill that had a $568B price tag, rather than the $2.25T price tag for President Biden's bill. As the dramatic swing between the two spending bills illustrates, there is a lot of room for negotiating and the initial salvo is rarely what actually becomes law.

Despite the long road ahead of all of this proposed legislation, it's important to understand the various proposals. Two bills of note were recently introduced that represent potential dramatic change to the transfer tax system we currently know and plan for: the **For the 99.5% Act** (Senator Bernie Sanders) and the **Sensible Taxation and Equity Promotion (STEP) Act** (Senator Chris Van Hollen, co-sponsored by Senator Bernie Sanders).

While these proposals have been introduced in the House and Senate, they have not been brought up for debate in either Chamber and are still a long way from becoming law. But, they do represent how some members of Congress are thinking about tax law changes, and represent the need for clients to start planning for any possible challenges even while they continue to hope for the best. Given the major impact these bills could have if they become law, we're going to break them down separately. The discussion of the For the 99.5% Act can be **found here**. As always, NFP will be here with you to keep you up to date on any potential changes to our current tax system.

THE SENSIBLE TAXATION AND EQUITY PROMOTION (STEP) ACT

We have lived through many different iterations of the estate and gift tax, with many changes to the exemption amounts and rates, so the proposals in the 99.5% Act are familiar. However, the STEP Act represents a significant and novel overhaul of the transfer tax system. Under current law, assets transferred by gift receive a "carry-over basis" with the donee taking the basis and any built-in gain that the asset had in the hands of the donor. This means that there is no tax recognition until the donee decides to sell the asset that was received by gift. In addition, at death, assets included in the taxable estate receive a step-up in basis, which eliminates any gain in the asset prior to being inherited.

The STEP Act would change both of those tax realities. Under the STEP Act, property transferred by gift, to a nongrantor trust or at death would be deemed to have been sold to the transferee for the property's fair market value on the date of transfer. The transferee would owe tax any capital gain associated with that deemed sale. Unfortunately, there is no recognition for losses triggered by this deemed sale, which means that careful basis planning would be required under the STEP Act.

The STEP Act has specific provisions for property transferred to trusts. In order to prevent permanent capital gains tax avoidance, property that is held by nongrantor trusts will have a deemed sale every 21 years. That's after the initial deemed sale that occurred upon transfer of the property to the nongrantor trust. Funded nongrantor trusts in existence prior to the effective date of the STEP Act will have their first forced deemed sale on December 31, 2026, and every 21 years thereafter. Large trusts will be required to provide the IRS with annual accountings that include balance sheet, income statements, trustee, grantor and beneficiary information. For grantor trusts, because under the current grantor trust rules the transferor is deemed to be the owner of the property for income tax purposes, the deemed sale of the property occurs when the property is transferred out of the trust to another person, when the grantor dies or when trust is no longer a grantor trust.

Within the STEP Act's provisions mandating recognition of capital gains on the transfer of property, there are a few exceptions. The first is for tangible personal property, other than collectibles, that's not owned in connection with a trade or business. Second, the STEP Act preserves the $250,000/$500,000 exemption for gains incurred due to the sale of a personal residence. Third, transfers to spouses or to charity would still receive carry-over basis so there is no deemed capital gain recognition on a transfer to a spouse or to charity. Fourth, capital gains incurred by an estate as a result of the deemed sale rules would be deductible by the estate against the estate tax, thereby avoiding double taxation on the assets. Finally, the STEP Act includes a lifetime exemption for the first $100,000 of capital gain recognized under the deemed sale rules, which increases to $1,000,000 for capital gain recognized at death, with both of these exemptions indexed for inflation.

Unlike the 99.5% Act, the STEP Act's effective date is December 31, 2020, which means that it would apply retroactively to transfers, gifts or bequests made starting on January 1, 2021. With the retroactive nature of the STEP Act, much attention needs to be paid to which gifts are made in 2021. This makes proactive planning to avoid the 99.5% Act more complicated, because a gift made during 2021 to take advantage of the current increased gift tax exemption amount could trigger capital gain recognition under the STEP Act, should it become effective. However, keep in mind that the capital gains tax rate is still much lower than the gift or estate tax rates, so making a gift tax exempt transfer that ends up triggering a capital gain will still likely result in an overall tax savings over holding the asset in the estate until death.

With the increased focus on raising revenue and changing the transfer tax system, our advisors will work with our clients to figure out the best plan for navigating all of these potential changes to ensure plans meet individual family needs and generate the best tax result possible.

For more information, visit NFP.com.