Tax Alert

On September 13th, 2021, the House Ways and Means Committee released its plan to pay for the $3.5 Trillion Build Back Better Act. The current proposal does not contain any changes that would be retroactive to the beginning of the year but does contain some changes that would be effective as early as September 13th, 2021. Many of the changes would take effect as of the legislation's enactment or as of January 1st, 2022.

At this point, this is only proposed legislation. It will be revised and amended prior to its enactment and will likely need the support of most House Democrats and all Senate Democrats to be enacted at all.

Still, we thought it would be helpful to summarize some of the key provisions and the proposed effective dates.

Unless stated otherwise, "high-income individuals" means married couples filing jointly with taxable income above $450,000, or single taxpayers with taxable income above $400,000.

1. **Top Capital Gains Tax Rate**
   A. The top capital gains tax rate would increase from 20% to 25%. There is also a 3.8% Medicare Surtax that would remain unchanged, making the total rate 28.8% (up from 23.8%).
   B. In 2021, the top rate applies to married couples filing jointly with taxable income above $501,600, and single taxpayers with taxable income above $445,850.
   C. ***This change would be effective for taxable years ending after September 13th, 2021***.
   D. The plan includes a transition rule, which stipulates that the old 20% rate would apply to gains realized ***on or prior to September 13th, 2021***. Gains recognized after this date but resulting from transactions entered into on or before this date (pursuant to a written binding contract) would also receive the old 20% rate.

2. **Top Marginal Individual Tax Rate**
   A. The top marginal individual tax rate would increase from 37% to 39.6% for high-income individuals.
   B. For individuals with MAGI over $5,000,000, there would also be a 3% surtax.
   C. This change would be effective for taxable years beginning after December 31st, 2021.
   D. A couple of observations:
      i. This **does not** directly raise taxes on those making less than $400k - a prior Biden promise (this does not account for indirect increases from corporate tax increases passed on to those individuals as workers or customers, or tobacco tax increases).
      ii. When including the net investment income tax (NII – see discussion below), the top marginal rate could be as high as 46.4% (39.6% + 3% surtax + 3.8% NII).
      iii. The Wall Street Journal reported that a household making $1 million in income would face a 10.6% tax increase.

3. **Top Corporate Tax Rate**
   A. The Corporate Tax Rate would change from a flat rate of 21% to a graduated rate topping out at 26.5%. Personal service companies are not eligible for graduated rates.
   B. Rates would start at 18% on the first $400,000, 21% up to $5,000,000 and 26.5% thereafter. The benefit of the graduated rate would phase out above $10 million.
   C. This change would be effective for taxable years beginning after December 31st, 2021

D. An observation: For companies reporting annual profits of $400,000 or less, the rate falls from 21% to 18%. For companies reporting annual profits between $400,000 and $5,000,000, there is no change in the tax rate.

4. Retirement Plans

A. If the combined values of an individual's IRAs, Roth IRAs, and defined contribution accounts reach $10 million as of the end of the prior taxable year, **<u>and</u>** the taxpayer is a high-income individual:
   i. No further contributions would be allowed for that year.
   ii. A new minimum distribution of 50% of the amount by which the aggregate balance exceeds $10,000,000 would be required in the following year. There are additional rules if the accounts exceed $20 million.

B. This change would be effective for calendar years beginning after December 31st, 2021.

C. Back Door Roth IRA strategies would be eliminated. The bill prohibits after-tax IRA contributions from being converted to a Roth IRA regardless of income level.

5. Estate and Gift Tax

A. The bill would reverse the doubling of the gift and estate tax exemptions created in 2017, returning them to their 2010 levels of $5,000,000 plus inflation. The doubling is already set to expire at the end of 2025, the bill would accelerate that expiration to after December 31, 2021.

B. For contributions made to existing grantor trusts or grantor trusts created ***after the date of enactment***, assets would be pulled back into the taxable estate when the decedent is the deemed owner of the trust. Also, sales between grantor trusts and their deemed owner would be treated as equivalent to sales between the owner and a third party. Thus, unlike the current law, income tax would be recognized on the sale. ***The above amendments would apply only to future trusts and future transfers.*** A few observations:
   i. It appears that swapping assets with a grantor trust on an income tax free basis (to exchange low basis assets for high basis assets) would no longer be allowed.
   ii. When the deemed owner of a grantor trust dies, the assets of that trust would be brought back into the deemed owners estate.
   iii. Any distribution from a grantor trust to someone other than the grantor or the grantor's spouse would be treated as a taxable gift from the grantor.
   iv. If the trust ceases to be a grantor trust during the grantor's lifetime, it would be treated as a gift by the grantor of all trust assets.
   v. Two popular estate planning vehicles, Grantor Retained Annuity Trusts (GRATs) and Spousal Lifetime Access Trusts (SLATs) would no longer work.
   vi. Insurance trusts are almost always grantor trusts. While existing insurance trusts would be grandfathered, it appears that future premium payments would bring a proportionate amount of the death benefit back into the grantor's estate. New insurance trusts would bring 100% of the death benefit back into the grantor's estate unless they could be drafted as a non-grantor trust.

C. No valuation discount would be allowed for non-business assets, even if they are owned by a business entity. Thus, when transferring a business, the valuation would be done in two steps: first value the non- business assets without applying a discount, then value the business assets applying an appropriate discount. ***This applies to transfers made after the date of enactment.***

D. What didn't change:

i. The maximum estate tax rate would still be 40%.
ii. There would be no changes to the treatment of dynasty trusts.
iii. There would be no changes to the annual exclusions.
iv. The gift tax exemption would remain unified with the estate tax exemption.
v. There would be no changes to the basis step up rule.
vi. There would be no triggering of capital gains tax when a gift is made or upon the death of a taxpayer.

6. Expanded Net Investment Income (NII) Tax (3.8%)

A. The Net Investment Income Tax would be expanded to apply to certain ordinary business income for high-income individual business owners.
B. This would not apply if FICA tax already applies.
C. This would be effective for taxable years beginning after December 31st, 2021.

7. Pass Through Entities

A. Pass Through Entities would face new limitations on the 20% deduction for qualified business income (Section 199A). The maximum allowable deduction would be $500,000 for high-income individuals.
B. This would be effective for taxable years beginning after December 31st, 2021.

8. Other

A. Private Equity fund managers would face new limitations on their ability to have carried interests taxed as capital gains.
B. Existing wash sale rules would be expanded to broader asset classes to include commodities, currencies, and digital assets.
C. There would be new limitations on deducting executive compensation.
D. There would be an expanded child-care credit to households with no income.
E. There would be no changes to the State and Local Tax (SALT) limitation.
F. There would be significant changes to the international tax regime.

The proposals summarized above include significant changes to the tax rates and rules for individuals, trusts, and estates. Again, please keep in mind that, currently, these are only proposed changes, subject to negotiation and amendment. It is also worth noting that some of these proposals face competing plans from the Senate and the Biden Administration. Until a bill is passed, we won't know exactly what changes may be enacted into law and when.

If you would like to discuss how these changes impact your planning please do not hesitate to reach out to us.