Recent House Tax Proposals

The House Ways and Means Committee recently released draft legislation that proposes significant changes to the tax code. Included are mostly tax increases and a few tax cuts. While this legislation is still in draft format, and subject to change, it covers a wide range of taxpayers. Please see below for a summary of the most pertinent potential changes. As we normally do, we have focused our alert on proposals that we felt were most relevant to privately-held businesses and individual taxpayers.

<u>Tax Proposals Affecting Individuals</u>

- **Increase in the top marginal income tax rate**
  - The top tax rate would increase from 37% to 39.6% for married taxpayers filing jointly with taxable income in excess of $450,000 and for single taxpayers in excess of $400,000. Note that some income currently subject to tax at the 35% rate would be subject to tax at the higher 39.6% rate. In addition, estates and trusts with more than $12,500 of taxable income would also be subject to this higher rate. This proposal is to be effective for tax years beginning after December 31, 2021.
  - *Planning point – Consider accelerating income into 2021, or deferring deductions into 2022.*
  - *Planning point – Trustees should consider making distributions to beneficiaries in lower tax brackets in order to lower the effective tax rate on the trust's total income (assuming the distributions are otherwise consistent with the terms of the trust and doing so would not create a significant increase in the beneficiary's taxable estate).*

- **Increase in the capital gains tax rate**
  - The current top rate of 20% would apply to long-term gains and qualified dividends recognized through September 13, 2021. For the remainder of 2021, an increased rate of 25% would apply to such income recognized from September 14 through December 31 to taxpayers currently subject to the 20% rate. For 2022 and future years, the 25% rate would apply to taxpayers beginning in the new 39.6% bracket. Note that any gains recognized in 2021 after September 13 would still be subject to the 20% rate if the gains result from having a written binding contract prior to or on September 13.

- **Increase the application of the 3.8% Net Investment Income Tax (NIIT)**
  - The NIIT would apply to cover net investment income derived in the ordinary course of a trade or business for joint taxpayers with more than $500,000 of income and single taxpayers with more than $400,000, to be effective for tax years beginning after December 31, 2021. Note that active S corporation shareholders would now be potentially subject to the NIIT on their S corporation income, including the sale of business assets.
  - *Planning point – This is another reason to consider accelerating business income and sales transactions into 2021.*

- **3% surcharge on high-income earners**
    - A tax would be assessed, equal to 3% of modified adjusted gross income in excess of $5 million for single, married filing jointly, or head of household taxpayers, in excess of $2.5 million for married taxpayers filing separately, and in excess of $100,000 of adjusted gross income for estates and trusts, to be effective for tax years beginning after December 31, 2021.
    - *Planning point – This proposal has an effective date of January 1, 2022, so there is significant incentive for large deals and transactions to close during 2021 to avoid this surcharge.*

- **Significant reduction in estate and gift tax exclusion**
    - The current estate tax lifetime exclusion is $11.7 million for 2021 and would be decreased to the 2010 level of $5 million, indexed for inflation, meaning a 2022 exclusion of approximately $6 million. This proposal would apply to gifts made and decedents dying after December 31, 2021.
    - *Planning point – If possible, consider gifting in 2021 up to the higher exclusion amount.*

- **Elimination of certain Roth conversions**
    - For IRA's and employer plans for joint taxpayers with adjusted taxable incomes over $450,000, and for single filers over $400,000, the ability to make conversions to Roth accounts would be eliminated. This proposal is to be effective for tax years beginning after December 31, 2031 (ten years from now).
    - *Planning point – Consider making Roth conversions while the opportunity exists by weighing the potential tax savings of the tax-free growth in the account to the tax cost of making the conversions.*
    - For tax years beginning after December 31, 2021, the proposal would prohibit all after-tax amounts held in a non-Roth account in an employer sponsored retirement plan or a traditional IRA from being converted to a Roth IRA or a designated Roth account.
    - The above would effectively ban the use of "back door" Roth contributions.

- **Required Minimum Distributions (RMD's) for larger IRA balances**
    - Taxpayers filing jointly with adjusted taxable incomes in excess of $450,000, and single filers with adjusted taxable incomes in excess of $400,000, whose aggregate retirement account balances exceed $10 million, would be required to take RMD's equal to 50% of any amount exceeding $10 million and 100% of any amount exceeding $20 million. This proposal is to be effective for tax years beginning after December 31, 2021.
    - *Planning point – Consider taking a distribution in 2021 to reduce your IRA balance (and to take advantage of the current, lower tax rates).*

- **Prohibition against certain IRA investments**
    - Individuals would no longer be able to own certain unregistered investments (such as private equity funds and hedge funds) in their IRA's, effective for tax years beginning after December 31, 2021. An IRA already holding such an investment would have two years to dispose of the unregistered investment or lose IRA status after December 31, 2023.

- **Limitation on use of grantor trusts**
  - Effective tax years beginning after December 31, 2021, the ability to establish new grantor trusts, or contribute to an existing grantor trust, as an estate tax savings vehicle would be significantly limited.
  - *Planning point – Consider accelerating substantial gifts to these types of trust arrangements prior to year-end.*

- **Certain inheritance tax proposals no longer included**
  - Previous iterations of Biden's tax proposals included provisions that would repeal the step-up in basis that occurs on a taxpayer's assets at the taxpayer's death. This idea is not included in the recent tax proposal.

<u>Tax Proposals Affecting Business Owners</u>

- **Reduction in maximum amount of Qualified Business Income Deduction (the 20% Section 199A Deduction)**
  - The maximum QBI deduction would be capped at $500,000 for joint filers and $400,000 for single filers, to be effective for tax years after December 31, 2021.
  - *Planning point – This is yet another reason to accelerate business income into 2021 to the extent possible.*

- **Limitation on excess business losses**
  - Current law limits excess business losses to $500,000. The proposal would disallow business deductions/losses in excess of business income/gains, to be effective for tax years beginning after December 31, 2020. In other words, business losses would be limited to $0.

- **Increase in the corporate tax rate**
  - The current flat 21% rate for C corporations would be replaced with a graduated rate as follows, to be effective for tax years beginning after December 31, 2021:
    - 18% on the first $400,000 of taxable income
    - 21% on taxable income up to $5 million
    - 26.5% on taxable income above $5 million (with a phase out of the graduated rate on corporations making more than $10 million)
  - *Planning point – Depending on the projected profitability/taxable income of the corporation, consider accelerating income into 2021.*

- **Modification to holding period for carried interests**
  - The holding period would be extended from three to five years to qualify for long-term capital gain treatment for taxpayers with adjusted gross income of more than $400,000. Said another way, a carried interest would need to be held for a minimum of five years (up from three) in order to receive long-term capital gain treatment upon sale. The holding period would remain at three years for certain interests in real property entities.

- **Repeal of certain Section 1202 stock benefits**
  - The special 75% and 100% exclusion rates for gains realized from qualified small business stock sales would not apply to taxpayers with adjusted gross incomes of $400,000 or more. This proposal would apply to sales occurring on or after September 13, 2021, except those sales occurring after this date that were made pursuant to a written binding contract which was in effect prior to September 13, 2021. Note that a 50% exclusion rate would be available.

- **Change in the GILTI rate**
    - The Section 250 deduction would be reduced from 50% to 37.5% for tax years beginning after December 31, 2021. This would create a GILTI tax rate of 16.5625% when combined with the 26.5% corporate tax rate.

- **Auto-enrollment in retirement plan mandate**
    - All employers with more than five employees receiving at least $5,000 in compensation would be required to offer a retirement plan with an auto-enrollment feature and that meets other requirements. Note that most existing plans would be grandfathered under the old rules.

Some of the above proposals will likely change. We will continue to monitor and communicate any changes to you. In the meantime, do not hesitate to reach out to us to discuss the ever-changing tax landscape.