Advanced Planning Group

EYE ON CONGRESS

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House and Senate Move Closer to Spending and Tax Bills that Will Likely Have Far Reaching Impact

On August 24th, 2021, the House of Representatives overcame the final procedural hurdle to potentially sweeping legislation set to be finalized later this year. With passage of the proposed budget resolution (which passed the Senate earlier in the month), a massive tax and spending bill described as 'once in a generation' is now poised to become the hallmark legislative accomplishment of congressional Democrats and the Biden administration. While very slim majorities in both chambers of Congress leave little room to maneuver, such reconciliation legislation can now bypass the Senate filibuster and be enacted with a simple majority of 50 Democratic Senators plus the Vice President to break a tie.

Current Status of Legislation

Bipartisan Infrastructure Plan and Budget Reconciliation

In spite of the bitter political divide that has characterized much of Washington in recent years, the Senate passed a nearly $1.2 trillion infrastructure spending bill (including $550 billion in new spending) on a largely bipartisan basis on August 11th. The bill was considerably smaller than the initial Biden proposal of a $2.3 trillion infrastructure plan, though the legislation does not include meaningful tax changes (funding is expected to come from unspent Covid relief, federal asset sales and additional borrowing). The infrastructure bill faces a less certain future in the House, as hoped for additional spending programs and tax increases will now be crafted in a second partisan package. Many Senators expressed a desire that the infrastructure bill be passed independently, though the House leadership seems intent on moving both bills in tandem, tying their legislative fates together (a vote on the infrastructure bill is scheduled in the House for 9/27/21). Of course, as the Democrats in the Senate and House effectively control the process at this point, they will be essentially negotiating with each other on final legislation. While the Tax Cuts and Jobs Act of 2017 ("TCJA") was a move towards broad based tax reform, legislation this year will largely be driven by desired spending levels coupled with revenue offsets.

While no specific legislation in direct relation to the 2nd spending bill has yet been released, several individually introduced pieces of tax legislation, as well as the Biden American Families Plan description, Treasury Green Book (which provide general explanations of the administration's fiscal year 2022 revenue proposals) and fiscal year 2022 budget resolution toplines provide an indication of what sorts of tax changes may be enacted. With a price tag that could reach as high as $3.5 trillion, the bill is likely to contain a number of considerable tax increases at both the business and individual level. The situation in Washington remains extremely dynamic and uncertain; however, the following is a summary of certain proposals that have attracted extensive attention by legislators and/or the White House. There may be others that arise as the negotiation process progresses and the ideas described below may be significantly modified or put aside.

Corporate Tax Changes

The President's initial infrastructure plan proposed an **increase in the corporate tax rate to 28%,** reversing a portion of the corporate rate reduction under the TCJA from 35% to 21%. Many legislators have expressed concern about increasing the corporate rate to such an extent, especially given the continued economic uncertainty and challenges as a result of the Covid pandemic. Anecdotally, indications are that a 25% or 26% rate may be palatable to a large swath of the legislators, as well as the wider business community. The Treasury proposal assumes the new rate would become effective starting in 2022 (as well as any portion of a corporate taxable year starting after January 1, 2021).

Additional corporate changes could include a minimum tax rate on foreign earnings at 21% (up from the 10.5% minimum established under the TCJA), and a 15% minimum tax on the "financial statement income" of large corporations. Overhaul of the U.S. corporate international tax regime may also be driven by the 15% global minimum corporate income tax framework as crafted this summer among the G-20 nations and the Organization for Economic Co-operation and Development backed by 132 countries.

Note that many businesses will also seek to take advantage of expanded tax credits proposed for clean energy, electric vehicles, and other climate related tax items.

Small Businesses Tax Changes

Several proposals are aimed at pass through business entities as well, which generally include partnerships, limited liability companies (LLCs) and S Corporations. Targeted areas include pass through deductions under 199A, self-employment taxes and the applicability of Net Investment Income Tax (NIIT) to certain business income of higher income taxpayers.

Medicare tax on all employment and wage earnings is generally imposed at a total effective rate of 2.9%. An additional .9% Medicare tax is imposed on such income for individuals with AGI in excess of $250,000 married/$200,000 individual: a total marginal rate of 3.8%. The NIIT likewise taxes investment income (generally passive income such as rents, royalties, dividends, interest, and capital gains) at a rate of 3.8% for individuals with AGI above the same thresholds. Limited partners, LLC owners claiming limited partner tax treatment, and S Corporation owners generally avoid Medicare tax on business income that does not constitute wages. S corp owners also generally avoid NIIT on distributions of business income where such owner materially participates in the business. The Green book proposes to change such tax treatment and **impose either self-employment Medicare taxes or NIIT of 3.8%** on more business income as follows:

- For taxpayers with AGI in excess of $400,000 (married or individual is not specified), NIIT would be imposed on gross income and gain from any trade or business not otherwise subject to

employment taxes; and

- S Corp owners, LLC members and Limited Partners who provide services and materially participate in a business (e.g., work for at least 500 hours per year) would be subject to self-employment tax on their distributive share of income to the extent it exceeds certain thresholds (tied to a $400,000 AGI level), though exemptions for certain items of passive business income would continue to apply.

This proposal would be effective for taxable years beginning after December 31, 2021.

Lastly, Senate Finance Chairman Ron Wyden (D-OR) (notably the chief tax writing Senate committee) introduced the Small Business Tax Fairness Act in July. Such bill would **phase out the Qualified Business Income Deduction** under IRC §199A as taxable income exceeds $400,000 (with complete elimination above $500,000). The bill would also eliminate the deductibility limits that currently apply to specified service trade or businesses (SSTBs). While no 199A changes were proposed in the Green book, Wyden's bill may warrant close consideration given that he is the Senate Finance chairman, as well as the anticipated need to generate a wide variety of revenue offsets for the broader spending bill.

Individual Tax Changes

While the new legislation is likely to include numerous low-income tax credits and expanded benefits for childcare, housing, earned income and education, high income individuals are likely to see several tax increases.

First among them is a proposed return of the **top marginal income tax rate to 39.6%** (from 37% currently). Note that the Green book proposal also narrows the current 35% tax bracket range, with income above $509,300 married/$452,700 single subject to the top 39.6% marginal rate starting in 2022, (reduced from the current (2021) threshold for the top marginal bracket of $628,300 married/$523,600 individual.

High income taxpayers could see a much more significant tax **increase on long term capital gains and qualified dividends**, which would be taxed at the top marginal ordinary rate for gains and dividends that exceed $1 million of a taxpayer's Adjusted Gross Income (AGI) (married or single, with such income level indexed for inflation). That would mean an effective tax increase of 82.4% as the marginal rate on such gains and income would be **43.4%** rather than the current 23.8% (including the Net Investment Income Tax (NIIT). Income tax planning to address large recognition events, even for taxpayers with relatively modest historical income will take on significantly increased import as a result.

Example tax consequences for an individual with a real estate investment purchased many years ago for $250,000 that generates $100,000 annually in rental income, assuming a sale for $2 million (ignoring any depreciation recapture):

	Current Law	Proposed
Ordinary Income (Rental)	**$ 100,000**	**$ 100,000**
Basis of Property	$ 250,000	$ 250,000
Sale Price	$ 2,000,000	$ 2,000,000
Gain Realization	$ 1,750,000	$ 1,750,000
AGI	$ 1,850,000	$ 1,850,000
Capital Gains Taxes Due	**$ 395,408**	**$ 562,008**
Capital Gains Tax Effective %	**22.6%**	**32.1%**
Capital Gain at 15%	$ 100,000	$ 100,000
Capital Gain at 18.8%	$ 245,850	$ 245,850
Capital Gain at 23.8%	$ 1,404,150	$ 554,150
Capital Gain at 43.4%		$ 850,000

Based on various comments emanating from legislators, there is a sense that the capital gains rate may see a notable increase for high earners, though such increase may not be as dramatic as the proposal indicates (e.g., a return to a top rate of 28% may split the difference and some past economic studies have suggested this is the revenue optimizing rate).

Equally notable is that the capital gains rate increase may be retroactive to some point in 2021. The Green book indicates an effective date of the "announcement" of the proposal (presumably a reference to the American Families Plan speech given by President Biden on April 28th, 2021). Other options could be the date of introduction or passage of the actual legislation. While possible, it is less likely that the effective date of the increase will be January 1, 2022, if only to prevent taxpayers from accelerating sales and recognition events, creating price distortions in the marketplace and uneven tax revenues (as occurred when the capital gains rate was increased under the Tax Reform Act of 1986 (enacted in October and effective at the start of 1987). Capital gains rate reductions in 1997 and 2003 were both made effective prior to enactment, while the 2012 ATRA rate increase was effective January 1st, 2013, though the bill was actually enacted the following day.

The **taxation of so called "carried interest"** has been widely discussed on and off by legislators for years, and the upcoming bill may finally be the moment the perceived dragon of a tax break for the ultra-wealthy is slain. Of course, if long term capital gains rates are increased as proposed, carried interest rule changes would be largely superfluous for high income taxpayers.

Partners in a partnership may own a capital interest (received in exchange for asset contributions) or a carried (née profits) interest (generally received in exchange for services to the partnership). When the partnership realizes long term capital gains (though a three-year holding period may be required), such gains are allocated among all partners. In the classic example, a private equity firm may use invested capital to acquire a company. If that company is subsequently sold at a gain, a portion of that gain is allocated to the managers, who generally earn their income through their allocable profits interest, with the balance allocated to the investors. The Green book proposal would effectively tax gains allocated to a profits interest in an "investment services partnership" (defined by reference to common private equity and hedge fund structures) as ordinary income (that is further subject to self-employment taxes) for taxpayers with income (from all sources) that exceeds $400,000.

Senate Finance Committee Chairman Ron Wyden (D-OR) has also proposed separate legislation requiring that unrealized **gains of derivatives be taxed annually at ordinary income tax rates**, subject to certain exceptions, including tax hedges. Addressing the complexity of derivatives taxation has been a focal point of discussion in prior tax bills, though annual realization that would require liquidation of investments to satisfy tax liabilities may create considerable market distortions.

Lastly, the Green book includes a **limit on 1031 like kind exchanges for real property to $500,000 of gain per taxpayer ($1 million married) per year.** 1031 like kind exchange treatment was limited to real property under the Tax Cuts and Jobs Act of 2017, though the new proposal can expect to meet considerable resistance from myriad real estate industry, investment, and business groups. Such proposal would become effective for exchanges completed after 2021.

While not mentioned in the Green book, changes to the $10,000 state and local tax **(SALT) cap** enacted under the TCJA continue to be pressed by Senators and Representatives from high income tax states. While full repeal of the cap is unlikely given the political optics (the limit largely impacts high income taxpayers) and overall tax cost, there is reason to believe that a degree of SALT relief may be forthcoming, especially to entice said legislators to offer their support for the bill. An increase to $15,000 single/$20,000

married, for example, has been discussed.

Wealth Transfer Tax Changes

Finally, several proposals impacting wealth transfer planning warrant close consideration. The TCJA increased the federal estate tax exemption to a level that exempts the overwhelming majority of individuals ($11.7 million single /$23.4 million married in 2021) from estate taxation, although this exemption will automatically be reduced by 50% starting in 2026 absent further action by Congress. Long established estate tax rules also permit an unlimited step up in basis to full fair market value at death for all assets included in the taxable estate, regardless of whether the estate is subject to estate tax.

Senator Bernie Sanders (I-VT) and several co-sponsors introduced the "For the 99.5% Act "in the Senate in March of 2021, proposing **a reduction of the estate tax exemption to $3.5 million per person** coupled with higher estate tax rates (increasing the current 40% to a graduated rate of 45% to 65% depending on the level of wealth). Sanders' bill also includes considerable changes to the overall wealth transfer planning environment, effectively eliminating valuation discounts, grantor retained annuity trusts (GRATs), and irrevocable grantor trusts (e.g., intentionally defective irrevocable trusts (IDITs).

Around the same time, a number of Senators introduced a discussion draft of the Sensible Taxation and Equity Promotion (STEP) Act, which mirrors the Biden Green book. While it is possible that elements of both proposals find their way into final legislation, the legislative focus seem more on the latter proposal that would **eliminate the full step up in basis at death for inherited assets**. The scope of assets that would be impacted by this proposal is not entirely clear. Another option to consider would be a repeal of the increase in the exemption enacted under the TCJA and reversion to the prior level in 2022 rather than 2026.

Both the STEP Act and the Biden Green book proposal would trigger taxation of "appreciated assets" transferred either by gift during life or at death. Some believe this is limited to appreciated capital assets that generally receive a step up at death under current law; however, the proposal is less than clear in this regard. Furthermore, the STEP Act would discourage long term trust planning by taxing every 21 years unrealized gains of assets held in trust. The Green book proposal, on the other hand, would limit such taxation to every 90 years, although the testing period would begin January 1, 1940 (triggering realization in existing trusts by December 31, 2030 at the earliest). Additionally, the 90-year recognition period would apply to partnerships and other "non corporate" entities.

Both the Step Act and the Green book trigger realization for gifts made in trust, while the Green book also triggers realization for transfers to partnerships and non-corporate entities. Presumably this would apply where transfers to such entity trigger a taxable gift and would not apply to tax free capital contributions done in the ordinary course of business.

Gain recognition would not apply to transfers to charity (though gain would apply to transfers to a split interest trust to the extent of the non-charitable portion of the transfer), nor would gain recognition apply to transfers to spouses who would maintain carryover basis. Household furnishings and personal effects (other than collectibles) would be excluded, and a $1 million lifetime exemption would be available to offset any realization by gift or upon death. Additionally, the $250,000 per person gain exclusion for the sale of a personal residence would remain available, as well as the exclusion for gains on small business stock (under IRC §1202). Note that the exclusion would act as a deferral rather than avoidance mechanism, as the donee's basis in property would be carryover to the extent the $1 million exclusion is applied by the donor/decedent.

Additionally, gain recognition would not apply to certain family owned and operated businesses until the business is sold or ceases to be family owned and operated. The capital gains tax would be payable over 15 years (plus fixed interest) for transfers at death other than liquid assets and publicly traded securities.

Capital losses and loss carryforwards would be available to offset gains for transfers at death. Additionally, capital gains taxes realized at death would be deductible for federal estate tax purposes (though no mention is made of an offset for gains realized through lifetime gifts).

While the STEP Act would apply retroactively, effective starting January 1, 2021, the Green book proposal would become effective starting in 2022.

For many sizable estates, the capital gains realization will add to the total transfer tax burden as illustrated in the following example of a $10 million estate (with $2M basis), and assuming the federal exemption reverts to $6 million:

	Current Law	Proposed
Estate Value	**$ 10,000,000**	**$ 10,000,000**
Basis of Assets	$ 2,000,000	$ 2,000,000
Gain Realization (Net of $1M Exemption)	$ -	$ 7,000,000
Capital Gains Taxes Due (23.8% and 43.4% Rates)	**$ -**	**$ (2,842,000)**
Estate Exemption (2026 or sooner)	$ 6,000,000	$ 6,000,000
Capital Gains Deduction	$ -	$ (2,842,000)
Estate Taxes at 40%	**$ (1,600,000)**	**$ (463,200)**
Total Taxes	**$ (1,600,000)**	**$ (3,305,200)**
Total Taxes as % of Estate	**16.00%**	**33.05%**
Basis of Donee/Beneficiary	**$ 10,000,000**	**$ 9,000,000**

Process at this Stage

The Various committees (12 in the Senate and 13 in the House) are now tasked with drafting the reconciliation bill, pieces of which are expected to be released later in September. Additional negotiations between various groups and key Senators will take place, with final legislation likely not coming to a vote until late in the year. Notably, Senators Joe Manchin (D-W.Va.) and Kyrsten Sinema (D-AZ) have expressed reservations about the significant spending proposed in light of current deficits and inflation concerns. Recent news regarding the insolvency of the Social Security trust fund as early as 2034 adds another dynamic, as well as the need for Congress to authorize a debt limit increase sometime in October or November (presumably on a strict party line vote as well). As a result, continued uncertainty remains, though the odds still favor passage of a bill in some form. While it may be smaller in scope than proposed, Democrats are heavily motivated to notch a legislative victory. The in-power party generally loses House seats in a mid-term election, so the window for legislation this broad and ambitious in scope is quickly narrowing, as Democratic leadership is well aware.

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