Evolving Tax Proposals - The Biden Budget and Green Book Have Even More Surprises for Taxpayers

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On May 28, 2021, the White House and Treasury released the Fiscal Year 2022 Federal Budget and the Treasury Green Book, or "Green Book", which includes new details regarding the Biden administration's proposed 2021 tax reform -- including a retroactive proposed capital gains tax increase to 37% to the extent household adjusted gross income exceeds $1M. The Green Book provides insight into the Biden administration's positions with respect to the various legislative tax proposals coming from Capitol Hill. The tax changes expected to be enacted this year will be substantial and far reaching and will include corporate, individual, and capital gains tax rate increases; international tax changes; and estate and gift tax changes, as discussed further below.

This alert addresses only a fraction of the tax changes expected to be enacted this fall; additional details will be released over time as congressional proposals take the form of draft legislation.

Retroactive Tax Changes? Maybe...

Many of the provisions of the 2017 Tax Cuts and Jobs Act (TCJA) that currently are scheduled to change or expire in the coming years will be addressed in the budget reconciliation package this fall and, as a result, may change or expire earlier than previously provided.

The effective dates of the newly enacted provisions generally are expected to be January 1, 2022, but certain provisions may have proposed effective dates tied to announcement, committee action or the date of enactment.

- Capital gains tax rate increases have been proposed to apply to "gains required to be recognized after the date of announcement [presumably late April, 2021]," and may be proposed by congressional committees to apply to

sales occurring after the date of announcement, congressional committee action, or the date of enactment of the legislation later in the fall.

- Historically, proposed effective dates for capital gains increases often have slipped to date of enactment of the legislation. The effective dates of certain provisions may be phased in over time, and certain provisions may be enacted on a temporary basis to help keep the scored cost of the legislation within acceptable parameters.

Observation: Depending on a taxpayer's specific circumstances, significant tax savings may be achieved by those who anticipate the expected changes and take steps now to take advantage of existing tax provisions and rates.

Corporate Tax Rate Increases and Related Changes

The Biden administration proposed an increase in corporate tax rates from 21 percent to 28 percent. Most believe the corporate rate will increase to no more than 25 percent.

For noncorporate taxpayers, it is unclear whether the Section 199A pass-through deduction may become unavailable, changed, or reduced. The Green Book is silent on Section 199A, but President Biden campaigned on limiting the Section 199A pass-through tax deduction for taxpayers earning in excess of $400,000.

The Green Book is also silent on Net Operating Loss ("NOL") carrybacks. However, 2021 tax legislation is expected to prohibit NOL carrybacks for tax returns not filed by the date of enactment.

The Biden administration's American Families Plan states that it will "permanently extend the current limitation in place that restricts large, excess business losses." IRC Section 162(l) generally disallows use of noncorporate losses in excess of $250,000 ($500,000 for joint filers).

The CARES Act removed the Section 461(l) limitation for tax years 2018-2020. The American Rescue Plan Act of 2021 ("ARPA") pushed out the current expiration of Section 461(l) from 2026 to 2027. The ARPA did not remove or change CARES Act provisions relating to Section 461(l).

The Biden administration also is proposing:

- Adding a 15 percent so-called minimum tax on corporations with more than $2 billion of "book income."
- Doubling the global intangible low-taxed income (GILTI) tax rate on foreign-sourced income, from 10.5 percent to 21 percent, and imposing it country by country and with no exclusion (or a lesser exclusion) for a deemed return on tangible assets.
- Eliminating the foreign-derived intangible income (FDII) regime.
- Replacing the base-erosion and anti-abuse tax (BEAT) with a so-called stopping harmful inversions and ending low-tax developments (SHIELD) proposal. SHIELD generally would deny tax deductions for certain

related-party payments where the recipient is in a low-tax jurisdiction.

- Imposing an "offshoring penalty" surtax on U.S. company offshore production profits for sales back into the United States (10 percent surtax leading to a 30.8 percent effective tax rate; it would also apply, for example, to offshore services or call centers serving the United States).
- Denying all deductions and expensing write-offs for moving jobs or production overseas.
- Establishing a 10 percent advanceable "Made in America" tax credit for certain service or call center jobs brought back to the United States.
- Providing or expanding tax credits and incentives for manufacturing, renewable energy, carbon capture and small businesses.
- Repealing fossil fuel tax preferences.
- Eliminating deductions for consumer drug advertising.
- Repealing bonus depreciation, including repealing the increase in bonus depreciation from 50 percent to 100 percent.

Observation: Certain of these proposals are not yet well defined and may be difficult to draft and administer. Others may be achieved only in part. All the proposals are relevant in the sense that they provide insight into what the 2021 reconciliation bill may attempt to achieve.

Going Up! Anticipated Increases in Capital Gains and Dividend Tax Rates for Higher-Income Taxpayers

- Proposed hikes in capital gains and dividend tax rates for certain higher-income taxpayers may result in increases from their current level of 23.8 percent (a 20 percent tax rate plus the 3.8 percent tax on net investment income) to 40.8 percent (a 37 percent capital gains rate plus the 3.8 percent tax on net investment income). The higher rates are proposed to apply "to the extent that the taxpayer's income exceeds $1 million ($500,000 for married filing separately)."
- The Biden administration's proposal would tax higher-income individual taxpayers on their long-term capital gains and qualified dividends at 37 percent, and short-term capital gains and ordinary dividends at an ordinary rate of 39.6 percent. It appears that a number of senators may be uncomfortable with capital gains rates in excess of 28 percent (31.8 percent once you add the 3.8 percent tax on net investment income); for now, taxpayers should anticipate at least a nominal increase of 8 percentage points (8/20=40%; 8/23.8=33.6%), or effectively a 33.6 percent increase in capital gains rates.

Observation: The shocker- the Biden administration has proposed that the capitals gains tax increase apply to gains recognized after the date of announcement [presumably late April 2021]. Most expect congressional committees will propose that increased capital gains rates apply at some date in 2021 tied to announcement, congressional committee action, or date of enactment. However, many practitioners believe, based on history, that those effective dates may slip and ultimately may apply to sales occurring on or after the date of enactment of the legislation. We also expect capital gains tax increases will apply to gains

recognized after the date of enactment.

Killing the Medicare Tax Loophole for Corporations

The Green Book explains that high-income (generally those earning more than $250,0000 for joint filers) workers and investors generally pay a 3.8 percent tax on net investment income, and a 3.8 percent Medicare tax (2.9% plus an additional .9% on wages over $250,000 for joint filers) on employment earnings. Application of these taxes is inconsistent across taxpayers, which the Biden administration states is "unfair…and provides opportunities …for those with high incomes to avoid paying their fair share of taxes."

The Biden administration proposes that all such taxes apply consistently to those making over $400,000. Specifically, the definition of net investment tax would include gross income and gain "from any trades or businesses that is not otherwise subject to employment taxes," and certain partnership income and S corporation income would be subject to employment taxes (and therefore the Medicare tax).

Carried Interest Changes on the Horizon?

A long-time target on profits from carried interest are further targeted by the Biden administration for taxation at ordinary income tax rates. The Biden administration proposes to eliminate application of Section 1061 for taxpayers with taxable income in excess of $400,000 and taxing as ordinary income those partner's share of income from an "investment services partnership interest" in an investment partnership to which they provide services. Such income also would be subject to self-employment taxes.

Another Monumental Change – Eliminating Like-Kind Exchanges

The like-kind exchange rules may be repealed for gains during a taxable year greater than $500,000 ($1 million for joint filers). The Green Book proposed effective date of like-kind exchange repeal is for "exchanges completed in taxable years beginning after December 31, 2021."

Observation: We expect taxpayers to lobby for helpful transition rules for sales completed before the date of enactment where title to qualified replacement property has not yet been obtained.

Individual Income Tax Rate Increases and Changes

For individuals (including households of joint filers) earning more than $452,700 in a calendar year, ($509,300 for joint filers) the Green Book proposes to increase the top marginal income tax rate from its current level of 37 percent to the pre-2018 level of 39.6 percent.

The Section 199A pass-through deduction, which allows certain pass-through business owners to deduct up to 20 percent of their qualified business income (leading to a current-law marginal rate of 29.6 percent), is not proposed to be changed by the Biden Administration, but may be repealed or carved back by congress for taxpayers with adjusted gross income in excess of $400,000.

The $10,000 cap on state and local tax (SALT) deductions may be repealed and replaced by congress with limitations on itemized deductions (i.e., phaseouts, a 28 percent cap on the value of itemized deductions, etc.) for taxpayers earning in excess of $400,000. The outright repeal of the SALT cap is expected to cost the government in excess of $600 billion over 10 years. The Green Book is silent on the SALT cap; views in congress vary widely among members.

A Backdoor Estate and Gift Tax Increase

The current estate tax and lifetime gift tax exemption (which was temporarily doubled until 2025) is $11.7 million per person ($23.4 million for married couples). In addition, there is a $15,000 per donee gift tax exclusion ($30,000 if spouses agree). The current estate tax rate on amounts in excess of the exemption amounts is a flat 40 percent, and the tax basis in inherited assets is "stepped-up" to the fair market value upon the death of the decedent.

During the presidential campaign, the Biden team stated that it would seek an increase in the estate tax rate to 45 percent and to reduce the exemption amounts to their pre-TCJA level ($5.3 million per person, $10.6 million for married couples). Oddly, the Green Book omits these changes and, instead, focuses on gain recognition.

- Specifically, the donor of an appreciated asset would recognize capital gains at the time of a gift in the amount of the excess of the fair market value of the asset as of the date of the gift over the donor's basis in such asset.
- Likewise, the estate of a decedent would recognize capital gains on appreciated assets at death. The recipient's basis in property received by reason of the decedent's death would be stepped-up to the fair market value as of the decedent's date of death. Such gain would be taxable income to the decedent on his or her federal gift or estate tax return or on a separate capital gains return.
- Assets transferred by a donor or a decedent to (i) a U.S. spouse or (ii) a charitable organization would retain a carry over basis. The use of capital losses and carry-forwards from transfers at death would be allowed against capital gains income and up to $3,000 of ordinary income on the decedent's final income tax return, and the tax paid would be deductible on the estate tax return of the decedent's estate.
- A $1,000,000 per-person ($2,000,000 per married couple) exclusion from recognition of unrealized capital gains on property transferred by gift or held at death, indexed for inflation after 2022, would be allowed and would be portable to a decedent's surviving spouse.
- The Biden administration's American Families Plan also provides that the payment of tax on the appreciation of certain family-owned businesses would not be due until the interest in the business is sold or the business ceases to be family-owned. The proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets.

Observation: Many Democrats in the House and of the Senate are expected to withhold their support for the imposition of capital gains taxes at death. Democrats generally seem supportive of imposing carryover basis at death.

- In addition to recognition of gain upon gifts and death, the Green Book also describes other transfer events that would trigger a capital gains tax. These events include transfers of an appreciated asset to or from a trust, partnership or other non-corporate entity (other than a grantor trust that is deemed to be wholly owned and revocable by the donor).
- Similarly, transfers out of a revocable grantor trust would be a recognition event to the extent such transfer is to someone other than: (i) the deemed owner, (ii) the U.S. spouse of the deemed owner, or (iii) a distribution made in discharge of an obligation of the deemed owner.
- Current law deems many of these transfers as non-recognition events and, thus, the proposed new changes would cause more frequent taxation of asset appreciation.
- The portability of exemption amounts between spouses generally is expected to continue, but many other planning techniques (including valuation discounts obtained in related-party transactions) presently utilized by taxpayers are proposed to be curtailed.

While it is worth noting that (i) the Tax Reform Act of 1976 would have imposed carryover basis on inherited assets, that provision was repealed before it could ever take effect, and (ii) the Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the estate tax and curtailed step-up in basis, but only for one year (2010). Treasury Secretary Janet Yellen has stated that elimination of the step-up in asset basis at death is a priority for the Biden administration.

The aforementioned proposals are set to be effective for gains on property transferred and on property owned at death by decedents dying, after December 31, 2021.

Securing a Strong Retirement Act's Proposed Changes to Retirement Plans

On May 5, 2021, the House Ways & Means Committee voted unanimously to send the *Securing a Strong Retirement Act* to the full House for consideration. The proposed legislation aims to increase retirement savings and simplify retirement plans with changes that include:

- Requiring automatic enrollment for 401(k) and 403(b) plans. Initial automatic enrollment must be at least 3% of pay, with 1% increases each year up to at least 10%. Participants may opt out at any point. The proposed legislation exempts existing plans in some cases, SIMPLE 401(k) plans, small businesses with 10 or fewer employees, and new businesses.
- Increasing the mandatory-distribution age for retirement plans from 72 to 73 in 2022, 74 in 2029, and 75 in 2032.
- Increasing the catch-up contribution limit for individuals age 62 to 64 from $6,500 to $10,000 for non-SIMPLE plans and from $3,000 to $5,000 for SIMPLE plans. Both limits would be indexed with the cost of

living.

- Requiring qualified plans, as well as 403(b) and 457(b) plans, to designate catch-up contributions as Roth contributions.
- Allowing qualified plans, as well as 403(b) and 457(b) plans, to provide participants the option of treating matching contributions as Roth contributions.
- Allowing plans to treat student-loan payments as elective deferrals for the purpose of making matching contributions under 401(k), 403(b), SIMPLE IRA, and 457(b) plans.
- Reducing the waiting time before plans are required to allow long-term, part-time workers into 401(k) plans from three consecutive years of service to two.

The bill also reduces required notices to unenrolled retirement plan participants and makes other changes aimed at increasing retirement savings and simplifying retirement plan administration.

Two senators—one Republican and one Democratic—have introduced a comparable bill in the Senate. The Senate bill has not yet gone through committee, and it differs from the House bill. A few key differences are that the Senate proposed legislation would: (i) not require automatic enrollment; (ii) increase the mandatory-distribution age only once, to 75 in 2032; and (iii) increase the catch-up limits at age 60 (rather than 62).

This bipartisan legislation previously was introduced in 2019. We expect this legislation to be included in the fall 2021 budget reconciliation bill or otherwise enacted within the next year or so.

Additional Clarifications, Details and Changes are Anticipated

As the Biden administration and congressional committees continue to work on tax and budget proposals, clarifications and details regarding the various proposals will emerge. Some of the initial proposals may be abandoned and revised, and additional proposals may emerge. As noted above, depending on a taxpayer's specific facts and circumstances, significant tax savings may be achieved by taxpayers who anticipate expected tax changes and take steps regarding their business plans, transaction pipelines, restructurings, operational affairs and estate plans in a manner that takes advantage of current tax provisions and rates.

The tax professionals at HCVT will continue to monitor tax reform proposed by the Biden Administration. As always, please contact your HCVT tax professional to discuss any questions you may have.