House Advances Significant 2021 Tax Changes

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PRACTICE AREAS

Tax

INDUSTRIES

Affordable Housing

Healthcare & Life Sciences

High Net Worth Individuals and Family Offices

Law Firms

Manufacturing, Retail & Distribution

Media & Entertainment

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Professional Services Firms

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Technology

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Introduction

On September 13, the House Ways and Means Committee released legislative text containing a significant number of tax change proposals targeting high-net-worth individuals, corporations, and owners of pass-through entities. These proposals overall have the effect of increasing taxes for the targeted groups and their owners. While the legislative text is still being debated and could change materially, it is expected to move through the House of Representatives in the coming weeks, with an expectation that it will be enacted in late 2021 as part of a fiscal 2022 budget reconciliation bill. The tax change proposals are intended to pay for the social and economic policies contained in the budget reconciliation bill, which also are still up for debate.

Summary

Based upon the information available to date, the following tables summarize certain key components of the House Ways and Means Committee's proposed legislative text, including how the provisions compare to those currently in existence from the 2017 Tax Cuts and Jobs Act (**TCJA**).

Individuals and Pass-through Entities

Provision

Current Law (TCJA)

After 2025 Sunset of TCJA

Current Legislative Proposals

Proposed Effective Date

Top Individual Tax Rate

37%

39.6%

46.4% **[1]**

Tax years after December 31, 2021

Top Long-Term Capital Gains Tax Rate

23.8% **[2]**

23.8%[2]

31.8% **[3]**

After

September 13, 2021

Expansion of Net Investment Income Tax [4]

Not applicable

Not applicable

3.8%

Tax years after December 31, 2021

3% Surtax
[5]

Not applicable

Not applicable

3%

Tax years after December 31, 2021

Section 199A/Pass-through Deduction

20% deduction on “qualified business income” from a pass-through entity

Will no longer apply after 2025

Deduction continues but is limited to $500,000 for a joint return, $400,000 for individuals, and $10,000 for estates and trusts

Tax years after December 31, 2021

Trusts and Estates

Provision

Current Law (TCJA)

After 2025 Sunset of TCJA

Current Legislative Proposals

Proposed Effective Date

Estate and Gift Tax Exemption

Exemption of $11.7 million for individuals and $23.4 million for married couples (indexed for inflation); top estate tax rate of 40%

Exemption of $5 million for individuals and $10 million for married couples (indexed for inflation); top estate tax rate of 40%

Exemption of $5 million for individuals and $10 million for married couples (indexed for inflation); top estate tax rate of 40%

Tax years after December 31, 2021

Grantor Trusts

Not applicable

Not applicable

Limitations on the ability to use grantor trusts as an estate planning tool

Trusts and transfers on or after the date of enactment

Estate and Gift Tax Valuations

Not applicable

Not applicable

Prohibits discounting the value of passive assets due to lack of control or partial ownership

Transfer after the date of enactment

Corporations

Provision

Current Law (TCJA)

After 2025 Sunset of TCJA

Current Legislative Proposals

Proposed Effective Date

Federal Corporate Tax Rate

21%

Not applicable

26.5% **[6]**

Tax years after December 31, 2021

GILTI [7]

10.5%

13.125%

16.5625%

Tax years after December 31, 2021

[1] This includes the top individual tax rate of 39.6%, a 3% surtax on individuals with modified adjusted gross income exceeding $5 million, and a 3.8% net investment income tax that covers net investment income derived in the ordinary course of a trade or business.
[2] Includes the 3.8% net investment income tax.
[3] This includes a 25% long-term capital gains tax rate, a 3.8% net investment income tax, and a 3% surtax on individuals with modified adjusted gross income exceeding $5 million. The increase in the base capital gains tax rate from 20% to 25% is proposed to be effective for most gains recognized after September 13, 2021, while the 3% surtax and expansion of the 3.8% net investment income tax would be effective beginning in 2022.
[4] Proposed legislation would extend the 3.8% net investment income tax to income derived in an active trade or business of a pass-through entity.
[5] Discussed below.
[6] The 26.5% is the top rate and applies to corporations with income greater than $5 million. See below for a discussion of the graduated rate structure.
[7] Defined below.

The following is a deeper dive into the legislative text, including initial considerations on what actions taxpayers should consider taking.

Individual and Pass-through Entities Overview

The proposed increases to the individual tax rate and the long-term capital gains tax rate applied to individuals earning greater than $400,000 per year and married couples earning greater than $450,000 per year. As described below, there are a number of other proposals however that significantly ratchet-up the top ordinary income tax rate to 46.4% (39.6% top ordinary tax rate + 3.8% expanded net investment income tax + 3% surtax) and the top long-term capital gains rate to 31.8% (25% top long-term capital gains tax rate + 3.8% expanded net investment income tax + 3% surtax).

1. Individual Income Tax Rate – The top individual tax rate would increase back to the pre-TCJA rate of 39.6% (from 37%). This would be effective for tax years beginning after December 31, 2021.
2. Long-Term Capital Gains Tax Rate – Would increase the tax rate on long-term capital gains and dividends from 20% to 25%. The increased long-term capital gains tax rate is proposed to generally apply to sales occurring after September 13, 2021 (unless pursuant to a binding contract in force on or before September 13, 2021).
3. Expansion of Net Investment Income Tax – Would expand the 3.8% net investment income tax to cover net investment income derived in the ordinary course of a trade or business of a pass-through entity that is not subject to FICA tax. The expansion would apply to individuals earning greater than $400,000 per year and married couples earning greater than $500,000 per year. It also applies to trusts and estates. This would be effective for tax years beginning after December 31, 2021.

4. Surtax on High-Income Individuals – Would impose a 3% surtax on yearly modified adjusted gross income above $2.5 million for individuals, $5 million for married couples, and $100,000 for trusts and estates. This would be effective for tax years beginning after December 31, 2021.
5. Phaseout Section 199A Deduction – Certain taxpayers who report "qualified business income" from pass-through entities such as LLCs and S corporations on their personal returns currently are entitled to a 20% tax deduction under Section 199A with respect to such income. The proposed legislative text would limit the maximum deduction under Section 199A to $500,000 per year for married couples, $400,000 per year for individuals, and $10,000 per year for trusts and estates. The proposal would be effective for taxable years beginning after December 31, 2021.
6. Elimination of Excess Business Losses – Would permanently disallow excess business losses (i.e., net business deductions in excess of business income) of a non-corporate taxpayer from offsetting non-business income in a taxable year. Instead, non-corporate taxpayers whose losses are disallowed may carry them forward to the next succeeding taxable year subject to the excess business loss rules for such a year. The proposal would be effective for taxable years beginning after December 31, 2020.
7. Carried Interest – Would extend the holding period for long-term capital gain attributable to carried interests from three to five years. The three-year holding period, however, will continue to apply with respect to certain real property trades or businesses and taxpayers with an adjusted gross income of less than $400,000 per year. The rules would apply to all assets that could give rise to long-term capital gain (that is, existing exclusions for certain specified items of long-term capital gain, such as Section 1231 gain, no longer would apply). The proposal would be effective for taxable years beginning after December 31, 2021.
8. Business Interest Expense Limitation - There are proposed changes to Section 163(j)(4), which limits the deductibility of business interest under Section 163(j) to partnerships and S corporations. Under the proposed changes, Section 163(j) generally will apply to a partner or shareholder, rather than to the partnership or S corporation as an entity. The proposal would be effective for taxable years beginning after December 31, 2021.

Observations:

- Phasing out of the qualified business income deduction for pass-through businesses likely would result in business income earned by owners of a pass-through entity being taxed at graduated rates as high as 39.6%.
- With the addition of a 3% surtax, consider whether a reallocation to tax-exempt investments or investments in assets that can be offset by depreciation is prudent.
- The carried interest proposal is quite different than the proposal advanced by Senate Finance Committee Chair Wyden, which would repeal section 1061 and impose a "deemed loan" construct that generally would require a carried interest holder to recognize certain ordinary income annually as well as a long-term capital loss for the same amount.

- Proposed legislative text does not eliminate like-kind exchange rules under Section 1031.

Trusts and Estates

1. Estate and Gift Tax Exemption – The current estate and gift tax exemption adjusted for inflation is $11.7 million for individuals and $23.4 million for married couples. The legislative text proposes to cut the exemption in half to an inflation-adjusted $5 million per person and $10 million for married couples to be effective after December 31, 2021.
2. Grantor Trust Treatment – There are a couple of significant changes to the grantor trust rules. The first would eliminate the ability to use grantor trusts to remove assets from an estate by requiring a grantor trust to be included in a decedent's taxable estate where the decedent was the deemed owner of the trust. Another would treat sales and other transfers between a grantor and an irrevocable grantor trust under the same tax rules that apply to a normal asset sale. These proposals would make it significantly more difficult and expensive for family businesses to keep control of those businesses in the family. These provisions would be effective for transfers on or after the date of enactment.
3. Estate and Gift Tax Valuations – Would change discount rules associated with partial ownership or lack of control of an asset by disregarding them for purposes of valuing the asset. This would only apply to passive assets that are not used in a business. Thus, discounted valuations are still permissible for assets held by active family businesses in the same manner as under current law. These provisions would be effective for transfers after the date of enactment.

Observations:

- The proposed legislation does not contain previous proposals from the Biden administration of taxing capital gains at death and prohibiting a step-up in basis at death.
- Given the significant reduction in the estate and gift tax exemption, taxpayers should strongly consider reassessing their estate planning needs and goals and evaluate whether some action should be undertaken by December 31, 2021.
- Consider making gifts prior to January 1, 2022, and exhausting the current estate and gift tax exemption before it is scaled back to a much lesser amount.
- The change in grantor trust status rules could severely hamper the future funding and consequently the premium funding for life insurance trusts. Most, if not all, of such trusts, are grantor trusts.
- SLATs generally must be grantor trusts; accordingly, such trusts may be effectively eliminated.
- Consider the use of, and contributions to, grantor trusts prior to the date of any legislative enactment (e. g., GRATs, installment sales, etc.).
- For families establishing grantor trusts now, they should strongly consider adding so-called "toggle off" provisions so these trusts can be modified and converted to complex trusts; they should also consider adding provisions allowing for the elimination of the spouse as a trust beneficiary.

- If families are hesitant to exhaust their transfer tax exemptions via gifts, they should at least consider making gifts in excess of $5,000,000 to capture the temporary increase; gifts of less will likely bring little value.

Corporations

1. Corporate Income Tax Rate – Would increase the corporate income tax rate from 21% to a graduated rate. The graduated rates would apply at a rate of 18% for corporations with an annual income of less than $400,000, 21% on annual income up to $5 million, and 26.5% on annual income thereafter. The graduated rates phase out for corporations with taxable income in excess of $10 million. In addition, the graduated rates do not apply to personal service corporations, which means they would pay corporate tax at the highest tax rate of 26.5% on their entire taxable income. The proposal would be effective for taxable years beginning after December 31, 2021.
2. Interest Expense Limitations – The proposed legislation has several changes to the interest expense limitations under Section 163. The first is the addition of a new Section 163(n) limiting the interest deduction for domestic corporations that are members of a multinational group that has consolidated financial statements and average annual business interest expense of more than $12 million. Section 163 (n) would limit an applicable domestic corporation's deduction to its allowable percentage of 110% of the total net interest expense. The allowable percentage is the ratio of the domestic corporation's allocable share of the group's net interest expense to such corporation's reported net interest expense, with the allocable share of the group's net interest expense calculated based on an EBITDA ratio. In addition, the proposed legislation would permit disallowed interest under Section 163(j)(1) or the new Section 163(n) to be carried forward for up to five years. The proposal would be effective for taxable years beginning after December 31, 2021.
3. Global Intangible Low Taxed Income – The proposed legislation has a number of significant reforms to the U.S. international tax rules, including the global intangible low-taxed income (**GILTI**) regime. GILTI is a category of income that is earned abroad by a controlled foreign corporation (**CFC**) (i.e., a foreign corporation that is more than 50% owned directly, indirectly, or constructively by 10% U.S. shareholders). GILTI requires a 10% U.S. shareholder of a CFC to include in current income the shareholder's pro-rata share of the CFC's "net tested income." The proposed legislation would reform the GILTI regime in a number of ways, including a) reducing the deduction related to GILTI from 50% to 37.5%, which combined with the increased corporate tax rate increases the GILTI rate from 10.5% to 16.5625%; b) requiring a country-by-country method for calculating GILTI with the ability to carryforward country-specific tested losses to future years' tested income; c) reduce the exemption from GILTI for the deemed rate of return on qualified business asset investment (**QBAI**) from 10% to 5%; and d) increase the amount of the deemed paid credit for foreign taxes attributable to GILTI from 80% to 95%. A transition rule is provided for taxable years that include but do not end on December 31, 2021.
4. Foreign Derived Intangible Income – FDII is the portion of a U.S. corporation's intangible income derived from foreign markets. The proposed legislation would reduce the deduction for foreign-derived

intangible income ("FDII") earned by a U.S. corporation to 21.875% (currently 37.5%). Reducing the deduction related to FDII from 37.5% to 21.875%, which combined with the increased corporate tax rate increases the FDII rate from 13.125% to 20.7%. Transition rules would apply for any taxable year that includes but does not end on December 31, 2021.

Observations:

- The increase in the corporate income tax rate from 21% to 26.5%, combined with taxing of dividends at higher rates for individuals making more than $400,000 per year could cause a significant increase to the effective tax rates of individuals who operate businesses through a corporation and distribute earnings.
- The proposed changes to GILTI are better in some respects than the Biden administration's plan. The roughly 16.56% effective tax rate is lower than the Biden administration's planned tax rate of 21% but still higher than the 15% tax rate promoted by the OECD. The proposed legislation also increases the amount of deemed paid foreign tax credits that may be attributable to GILTI from 80% to 95%, with the result that companies subject to a 17.4% or a greater tax rate of tax in a foreign country may have no residual GILTI liability. It also surprisingly retains the ability to reduce GILTI through QBAI, which the Biden administration's plan targeted as an incentive to invest in tangible assets abroad and thus eliminated entirely. The ability to carry forward losses is a welcome addition, but the transition to a country-by-country regime is significant as it eliminates the ability of a U.S. shareholder to blend high-taxed GILTI against low-taxed GILTI.
- Consider accelerating recognition of taxable income into 2021 and also which deductions could be deferred until after 2021.
- Consider exit and succession plans.

<u>Other Provisions of Interest</u>

1. <u>Qualified Small Business Stock</u> – Non-corporate taxpayers may exclude some or all of their gain from the sale of Qualified Small Business Stock (QSBS) held for more than five years. For QSBS acquired from the date of enactment in 1993 through February 17, 2009, gain excluded from income is equal to the maximum amount of gain eligible for exclusion multiplied by a 50% exclusion rate. The exclusion rate was increased to 75% for QSBS acquired between February 18, 2009, and September 27, 2010, and the exclusion rate was increased to 100% for QSBS acquired on or after September 28, 2010. For taxpayers with an adjusted gross income of $400,000 or more, and for all trusts and estates, the proposed legislation would cap the exclusion rate at 50% thus eliminating the 75% and 100% exclusion rates, which would significantly reduce the provision's tax benefits.
2. <u>Temporary Provision to Allow Eligible S Corporations to Reorganize as Partnerships Without Tax</u> – The proposed legislation would allow an eligible S Corporation (i.e., an S Corporation on May 13, 1996, and all times thereafter) to convert to a partnership without incurring tax on the deemed liquidation. This proposal would be effective for transactions occurring on or after December 31, 2021, and before January 1, 2024.

3. Amendments to IRA Rules – To avoid subsidizing retirement savings once account balances reach high levels, the proposed legislation would prohibit additional contributions and increase the minimum required distributions (regardless of age) for high-income taxpayers when the total value of an individual's IRA and defined contribution retirement accounts exceed $10 million (adjusted for inflation) as of the end of the prior taxable year. The mandatory distribution requirements would equate to 50% of the amount over $10 million, with the 50% excise penalty applying for failure to withdraw the excess amount. The proposal is effective for taxable years beginning after December 31, 2021. The proposed legislation would also prohibit an IRA from investing in non-registered securities in reliance on the "sophisticated investor" exception of Rule 506 of Regulation D. This proposal would be effective after December 31, 2021, for new investments and after December 31, 2023, for existing investments.
4. Wash Sales and Constructive Sales – Cryptocurrencies – Would increase the scope of the current wash sale rules to include actively traded commodities, publicly traded partnership interests, foreign currencies, and many cryptocurrencies and other digital or virtual assets. The wash sale rules apply to disallow an initial loss where an investment is sold at a loss and then repurchased within 30 days. The proposed legislation would also expand the constructive sale rules to extend to appreciated cryptocurrencies and other digital and virtual assets. The constructive sale rules apply where a taxpayer has an appreciated financial position or short position and attempts to mitigate their risk in the position by entering into an offsetting position. The rule requires current recognition of gain on the underlying position even though the taxpayer continues to own it. The wash sale provisions would be effective for taxable years beginning after December 31, 2021, and the constructive sale provisions would be effective for constructive sales after the date of enactment.
5. Executive Compensation – Would accelerate the applicable date for the expanded rules limiting the deductibility of executive compensation to $1 million for publicly held corporations. The American Rescue Plan Act of 2021 (**ARPA**) expanded the current compensation deduction limitation under Section 162(m) to cover five additional highly compensated employees. Prior to ARPA, these limitations applied to compensation paid to a publicly held corporation's Principal Executive Officer, Principal Financial Officer and the three highest-paid other officers. APRA expanded this limitation to cover five additional highly compensated employees. The APRA changes to Section 162(m) are effective for tax years beginning after December 31, 2026. The proposal would accelerate the timing of this change to tax years beginning after December 31, 2021.
6. Increased IRS Funding – Would increase the IRS's congressional funding by $80 billion over the next 10 years. The increased funding will serve to increase the IRS's tax enforcement efforts with respect to high-net-worth individuals. The Congressional Budget Office has stated that the increased funding could lead to an additional $200 billion in additional federal tax revenue.
7. Foreign Tax Credit – Would require foreign tax credits to be determined on a country-by-country basis, which would prevent taxpayers from using excess foreign taxes paid to high-tax countries to reduce their U.S. tax liability on income earned in low-tax countries. Would also reduce the excess foreign tax credit carryforward period from 10 years to 5 years and repeal the current 1-year carryback.

Observations:

- The extension of the wash sale rules and constructive sale rules to cryptocurrencies significantly limits the ability of investors and traders of cryptocurrencies to 1) harvest losses from cryptocurrencies to offset other capital gains; and 2) mitigate the risk associated with appreciated positions in cryptocurrencies, which are known to be a volatile asset class, through entering into offsetting positions.
- The proposed effective date for the wash sale rules of tax years beginning after December 31, 2021, is problematic for taxpayers that invest in or trade cryptocurrencies as it is one-year before the proposed effective date of separate proposed legislation that delays until January 1, 2023, the requirement that "brokers" of digital assets report a customer's cryptocurrency trading activity (potentially including wash sales) on a Form 1099-B. Thus, taxpayers that invest in or trade cryptocurrencies will be presented with significant challenges on how to comply with the wash sale rules. In addition, taxpayers that are in the trade or business of trading cryptocurrencies still lack clarity on whether they qualify for a mark-to-market election under Section 475, which would potentially exempt them from the wash sale rules.

How HCVT Can Assist

HCVT can assist clients in a number of ways, including 1) determining whether it may make sense to accelerate income in 2021 in anticipation of higher rates; 2) determining whether a business should consider deferring expenses or accelerating income, depending on its facts and circumstances; and 3) evaluating estate plans and whether it makes sense to amend them.

This is proposed legislation that will likely be subject to debate and may change and requires passage by the House, Senate, and signature by President Biden. As we near year-end, we are here to assist you with planning. Please contact your HCVT tax professional to discuss the potential impact on you and your business.