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Proposed Tax Changes — Build Back Better Framework

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INTRODUCTION

After months of speculation, President Biden's human infrastructure agenda was narrowed and "right-sized" in the Revised Framework (the Framework) outlined by the President on October 28, 2021. The Framework was then further updated on November 3, 2021, by the House Rules Committee (the Updated Framework) to include several additional revenue raising proposals and state and local tax relief. The contours of the Updated Framework will be specified in legislative text and become the latest version of the House Bill H.R. 5376, also known as the Build Back Better Act (the Act). The Updated Framework may receive more attention for what it excludes as opposed to what is included in it. Most notably, here are some excluded items:

- No change to individual ordinary income tax rates for taxpayers with income below $10 million
- No change to individual capital gains/qualified dividend tax rates for taxpayers with income below $10 million
- No change to estate, gift and GST tax exemption amounts or rates
- No change to step-up in basis rules and no deemed realization at death
- No unrealized appreciation (anti-deferral accounting) annual taxation
- No change to grantor trust rules
- No change to valuation discounts
- No change to C corporation tax rates
- No change to 20% qualified business income deduction under IRC 199A
- No change to carried interest rules

While much of this is welcome news, the Updated Framework is still far from making it across the finish line. There is a good chance there could be further modifications in the House and still further changes in the Senate. One particular item is missing from the Updated Framework: there is no provision increasing the debt ceiling, which would need to be addressed in a reconciliation bill if Republicans do not lend support for a bipartisan vote to increase governmental borrowing.

Just as the non-tax provisions of the Act are narrowed by the Framework, so too are the tax provisions. The President's Framework contains $1.85 trillion of proposed tax increases, down from the $2.1 trillion as previously proposed.[1] However, the Updated Framework raises only $1.48 trillion in revenue, but that estimate does not include revenue resulting from enhancement of IRS enforcement (a revenue estimate will be provided by the Congressional Budget Office in due course—however, the President expects to generate $400 billion from increased tax enforcement). Tax proposals aimed at upper income taxpayers are expected to raise about $650 billion, while corporate and international tax proposals are expected to raise about $814 billion.

New Tax Surcharges on Gross Income

A new tax surcharge would be imposed on a variety of (non-corporate) taxpayers—individuals, trusts and estates—in a two tier structure. The surcharge would apply to only the top 0.02% of taxpayers (approximately 22,000 tax returns reported income that could be subject to the surcharge, based on IRS data from 2018).

First tier—a surcharge of 5% would apply to individuals with modified adjusted gross income in excess of $10 million. This threshold is the same for married couples filing jointly and single taxpayers. However, if a married couple files separate tax returns, the threshold drops to $5 million for each of them.

For a non-grantor trust or an estate, the threshold drops to $200,000. This low threshold is further confirmation of Congress' suspicion of trusts.

Second tier—an additional surcharge of 3% would apply to individuals with modified adjusted gross income in excess of $25 million. This threshold is the same for married couples filing jointly and single taxpayers. However, if a married couple files separate tax returns, the threshold drops to $12.5 million for each of them.

For a non-grantor trust or an estate, the threshold drops to only $500,000.

In either case, the surcharge is determined and applied for all income (i.e., wages, dividends and gains) in excess of the modified adjusted gross income thresholds (modified adjusted gross income is essentially, gross income, reduced by investment interest expense). For individuals it is important to note that charitable deductions (and other itemized expenses) do not reduce the income potentially subject to the surcharge. However, when it comes to trusts and estates, the surcharge is based on adjusted gross income under IRC 67(e). Adjusted gross income (AGI) for a trust or estate is not computed in the same manner as an individual. AGI for a trust/estate can be offset by deductions for certain expenses to administer the trust/estate. Unlike an individual taxpayer, a trust or an estate can offset its income by charitable deductions. This modification was added in the November 3rd Updated Framework. As a result, of this proposed modification, there could be planning opportunities for creating and funding trusts to facilitate charitable gifts.

The surcharge is proposed to be effective beginning in 2022.

Observations: taxpayers should be mindful of anticipated gross income and attempt to keep themselves below the thresholds to the extent practical. For instance, a sale of securities could straddle two tax years, rather than be bunched up in a single year. When selling a business, taxpayers may find it beneficial to receive payments over a period of years and use installment sale tax treatment to spread the gain over several tax years. For example, a sale of a business under an installment sale could be structured to keep the proceeds under $10 million annually.

There could also be a planning opportunity for accelerating gains into the current (2021) tax year. No surcharge would apply this year (2021) regardless of income level. However, a sale next year may be subject to the surcharge.

Given the lower thresholds in place for non-grantor trusts and estates, it could be difficult to avoid the surcharge. Trustees could consider distributions of appreciated property to beneficiaries so that the gain in the property could generally be taxable to the beneficiary upon sale, rather than to the trust. Trustees might also consider distributions of income to beneficiaries which could reduce trust income in order to avoid the surcharge.

The surcharge could be a strong impediment to accumulating wealth inside a non-grantor trust. For instance, a trust with income of $500,000 would pay a marginal tax rate of 45% on its next dollar of income, whereas an individual with similar income would be in a 37% bracket—a rate differential of 8% but a tax increase of 22%. The material rate differential would also create a further incentive to shift the income to the settlor by creating the trust as a grantor trust. After the grantor's death, the trust could consider distributing income to its beneficiaries in an effort to reduce taxable income of the trust and shift such income to individual beneficiaries who may be well below surcharge thresholds.

Taxpayers may want to also give thought to smoothing income and recognizing capital gains over an extended time period so as to avoid a sharp increase in income in a single year and the accompanying surcharge(s). While a sale of marketable securities cannot be made on an installment basis, a sale could be made through a charitable remainder trust, which could replicate an installment sale. Taxpayers selling businesses could also consider recognizing income over a period of time rather than in a single tax year. It appears that charitable remainder trusts are not subject to the surcharge but confirmation from the Treasury would be welcomed.

Qualified Small Business Stock

In a surprise to taxpayers, the House's Ways and Means Committee tax proposal included a provision limiting the tax benefits of sales of qualified small business stock (QSBS). The

[1] The Framework proposes approximately $1.75 trillion in new spending, down from $3.5 trillion. The Framework also narrowed the corporate tax increases and abandoned the rate increase for domestic corporations. In lieu of the rate increase, the Framework includes a 15% corporate minimum tax on large corporations, a stock buyback excise tax, and other reforms focused on multinational corporations.

Updated Framework continues that limitation, with a slight modification on the effective date. Under the Updated Framework, taxpayers with adjusted gross income of $400,000 or more, could exclude only 50% of the eligible QSBS gain, regardless of when the qualified small business stock was issued. All estates and trusts would also be limited to the 50% exclusion limitation. The change would be effective for sales after September 13, 2021, although there is an exception for sales subject to a written, binding contract that was in effect on or before September 13th.

Prior to the proposed change, (generally) up to $10 million of QSBS gain could be excluded from income. Under the Updated Framework, $5 million of the $10 million of QSBS gain would be excluded from income and the other $5 million would be subject to a capital gains tax of 31.8% (28% + 3.8%) if the sale is in 2021 or up to 39.8% (28% + 3.8% +5% + 3%) if the sale is in 2022 and various surcharges applied. Any gain in excess of the $10 million threshold would be subject to capital gains rates of up to 23.8% (including the net investment income surtax) in 2021 or 31.8% (including the net investment income surtax and the various surcharges) in 2022.

Because there is still a benefit from the sale of QSBS stock, taxpayers may still want to consider planning with such stock, which may include gifts of such stock to non-grantor trusts or outright to children or others to leverage the QSBS exclusion. Moreover, because of the potential higher 2022 rates due to the proposed surcharges, taxpayers expecting significant gains may want to consider the merits of selling in 2021 versus 2022.

Net Investment Income Tax

The Updated Framework would expand the 3.8% surtax on net investment income to cover active business income (or gain) from a trade or business (including pass-through entities such as S corporations and partnerships), if that income is not otherwise subject to FICA or SECA tax.

A principal effect of the Updated Framework's proposal is that S corporation shareholders, limited partners, and LLC members who currently are not liable for FICA or SECA tax, respectively, on their pro rata shares, distributive shares, and partnership income and gain will now become subject to the 3.8% NII tax on this income and gain above certain income thresholds. The 3.8% tax would apply to taxpayers with modified adjusted gross income in excess of $400,000 (if single) and $500,000 (if married filing jointly). For taxpayers with income just over that amount, the 3.8% surtax would be phased in.

The surtax would also apply to trusts and estates. In the case of an estate or trust, the NII tax is 3.8% of the lesser of (1) the greater of undistributed specified net income or undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

Currently, the 3.8% net investment income tax only applies to passive income. The effective date for the expanded surtax would be for taxable years beginning after December 31, 2021.

State and Local Tax Deductions

We all knew it was coming, but it took a while. The Updated Framework now contains proposed relief for taxpayers whose deductions for state and local real estate and income taxes were capped at $10,000. The Updated Framework increases the deduction to no more than $80,000 (or half that amount for married taxpayers filing separately). Trusts and estates will always be limited to $40,000.

This proposed change would be effective for the current tax year (2021) and would continue in effect through 2030. Then for one year (2031) the cap would revert back to the current $10,000 limit, before being removed entirely. Under current law, the $10,000 cap is slated to be removed in 2026. By temporarily increasing the cap and extending its duration through 2031, the proposed SALT change includes its own revenue raising mechanism and actually is expected to raise $2 billion over the 10-year budget window.

Retirement Provisions

The House's tax proposal contained several revenue raising provisions aimed at curtailing retirement plans that had so-called "mega" balances. Those proposals were jettisoned in the President's Framework but were resurrected in the Updated Framework.

Large Retirement Account Balances—If a taxpayer holds a large balance in retirement accounts and is a high-income taxpayer, per the balance and income thresholds below, then:

- **No additional IRA contributions** allowed (qualified plan contributions would be allowed)—an excise tax would apply. Certain additions to IRAs would be ignored.
- **New minimum required distributions:** equal to the excess (if any) of (a) the sum of (1) 100% of the "applicable Roth excess amount" (defined below) plus (2) 50% of the "excess aggregate vested retirement plan balance" (defined below) reduced by the applicable Roth excess amount over (b) the sum of the minimum required distributions (determined without regard to this proposal) for all such plans.
- **New RMD requirement for Roth IRAs:** If aggregate IRA balances exceed $20 million—then the full excess must be withdrawn to the extent it consists of a Roth IRA or a Roth designated account. This is called the "applicable Roth excess amount."

For the foregoing proposals to apply, two conditions must be met: (1) the individual must be a high-income taxpayer: someone with adjusted taxable income for the year which exceeds $450,000 for a married couple, $400,000 for a single taxpayer, AND (2) the aggregate vested retirement plan balance for such individual must exceed $10 million, the "excess aggregate vested retirement plan balance" (indexed for inflation commencing in 2030). "Retirement plan" includes a qualified defined contribution plan or annuity; a tax-deferred annuity, a government deferred comp plan or IRA. Retirement plan balances would be determined on December 31, of prior year.

If a minimum distribution is triggered, there would be no 10% tax on the early distribution. However, all distributions from non-IRA plans (e.g., qualified plans) would be subject to a 35% income tax withholding requirement. This proposal would be effective for taxable years beginning after December 31, 2028.

Additional reporting for defined contribution plans—The Updated Framework also includes new reporting requirements for defined contribution plans. Plan sponsors would be required to report participants' vested balances exceeding $2.5 million to the IRS, and identify Roth versus non-Roth amounts held in the plan.

Roth Conversions—No future Roth Conversions of tax deferred retirement assets for high-income taxpayers: In the case of a high-income taxpayer [adjusted taxable income for the year which exceeds $450,000 for a married couple, $400,000 for a single taxpayer], (1) funds held in traditional IRAs may not be converted to a Roth IRA and (2) funds held in a 401(k) plan (non-Roth portion), 403(b) plans, and governmental section 457(b) plans may not be converted into either a Roth 401k account or a Roth IRA. This proposed change would apply to distributions, transfers, and contributions made in taxable years beginning **after December 31, 2031.** Taxpayers could still distribute (rollover) funds from Roth IRA or Roth 401k accounts to a Roth IRA.

No Back-Door Roth Conversions—For all taxpayers (regardless of income level), the Updated Framework includes a proposal that prohibits amounts held in non-Roth accounts in (i) an employer-sponsored retirement plan or (ii) in a traditional IRA from being converted to a Roth IRA or a Roth 401k **if any portion of the distribution that is being converted consists of after-tax contributions.** This proposal would be effective for distributions, transfers, and contributions made **after December 31, 2021.**

OTHER ITEMS

Constructive Sales—the Updated Framework continues the House's proposal to tax certain transactions as sales, even if the underlying holding is not actually disposed of. The proposed change is designed to prevent taxpayers from locking in investment gains without realizing a taxable gain. Digital assets would be included in the constructive sale rules (currently, the constructive sale rules generally apply to financial assets). The term 'digital asset' generally means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary. The House's original proposed tax plan would have taxed constructive sales commencing January 1, 2022. The Updated Framework would change that and tax constructive sales made after the date of enactment.

Wash Sales—The Updated Framework continues the House's proposal to modify and expand wash sale rules. The proposal would expand the scope of the rule from sales or dispositions of shares of stock or securities to sales, dispositions, or terminations of specified assets. "Specified assets" would include an expanded scope of assets, including crypto-currencies (any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Treasury Secretary), foreign currency, and certain commodities. The proposal would also expand the wash sale rules so that they apply if the taxpayer or a related party acquires substantially identical specified assets.

The effective date for the expanded wash sale rules would apply to sales, dispositions and terminations after December 31, 2021.

Internal Revenue Service Funding—The Updated Framework would provide additional funding for the IRS for the purpose of hiring enforcement agents, modernizing outdated IRS technology, and improving taxpayer service. According to the summary of the Updated Framework, the "additional enforcement resources will be focused on pursuing those with the highest incomes; not Americans with income less than $400,000."

CONCLUSION

The House's Updated Framework is yet the latest of many proposals for potential tax changes released this year. With spending significantly curtailed compared to the House Ways and Means Proposal from September, the revenue raising provisions of the Updated Framework have likewise been reduced. In fact, most of the broader-based individual and corporate tax increases proposed over the course of 2021 are notably absent from the Updated Framework. However, the impact of these potential tax changes on high income taxpayers, may still be substantial, as the proposal seeks to increase taxes on the very highest earners through surcharges, and eliminate certain tax breaks that often benefit wealthy taxpayers. Although the smaller price tag of this bill represents significant progress in appeasing moderate Democrats who balked at the $3.5 trillion Ways and Means bill, there is work to be done before the proposals become law, and support for this proposal from both moderates and progressives is not a given. As Congress gets closer to a spending bill acceptable to the various factions of the Democratic Party, the likelihood of these proposed tax changes becoming reality will increase.

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Important Disclosures