Nautilus Newsflash: Tax Legislation Updates as of September 15, 2021

The recent Nautilus Eye on Washington article outlined various business, individual, and wealth transfer tax proposals that may be included in new legislation later this year. On September 13th, the House Ways and Means committee released draft legislation that lays out an initial jumping off point for negotiations between the various caucuses within the House. The Senate Finance committee is expected to develop its own proposals; the key in all discussions will be obtaining sufficient votes to pass a bill given the extremely narrow majorities (Democrats can lose no more than 3 Reps in the House, while all 50 Democratic Senators must sign off on any bill), as well as the divergent policy goals within the party itself. The only certainty at this stage is that the legislation will continue to evolve as discussions continue. ***Note that any proposed legislation at this stage is simply that – PROPOSED – and will remain subject to continuous revision and even wholesale replacement.***

Notable items within the draft legislation that differ from earlier proposals include:

Individual Tax Changes

The Biden proposed **top capital gains tax rate** of 39.6% has been scaled back to **a 25% rate** (28.8% total including the Net Investment Income Tax (NIIT)). While the Biden proposal would apply the new rate at $1 million of adjusted gross income (AGI), the bill would apply the higher rate at the top marginal income tax bracket (itself increased to 39.6%). The top marginal bracket threshold would be lowered considerably as well to $400,000 single/$450,000 married filing jointly (current brackets are $523,600 single/$628,300 married filing jointly). The capital gains rate increase would generally **apply to gains and dividends realized after September 13th, 2021**.

Individual income tax rates would be applied as follows: 35% rate to apply to income between $400,000 and $450,000 for married couples filing jointly, and 39.6% above such threshold; 35% rate between $200,000 and $400,000, and 39.6% above such threshold for single filers. The new rates and thresholds would go into effect in 2022. A **3% additional surtax will apply to individual taxpayers with income above $5 million** (for a 42.6% top marginal rate). The **3% additional tax will also apply to estates and trusts with income above $100,000**.

Lastly, high income taxpayers will face certain restrictions with regards to their IRAs and qualified retirement plans, namely:

- Taxpayers with IRA balances in excess of $10 million and income above $400,000 single/$425,000 married filing jointly will be precluded from making contributions to their IRAs starting in 2022;
- Taxpayers with income above $400,000 single/$450,000 married filing jointly will have new (penalty-free) RMDs of half of any total account balances exceeding $10 million, as well as Roth balances to the extent that total IRA and qualified plan balances exceed $20 million, starting in 2022;
- Taxpayers with income above $400,000 single/$450,000 married filing jointly will be precluded from converting IRAs and employer plan accounts to a Roth (starting after *2031* (though that may be a mistake)), while all taxpayers will be prevented from converting after tax IRA contributions to a Roth (so called back door Roth planning) starting in 2022.

Business Tax Changes – All effective for tax years after 2021

As proposed, the **3.8% net investment income tax will apply to trade or business income** (that is not otherwise subject to Medicare taxes) of taxpayers with income above $400,000 single/$500,000 married filing joint.

The **§199A Qualified Business Income** (QBI) tax deduction would be capped at a **total deduction of $400,000 single/$500,000 married filing jointly** (and $10,000 in the case of an estate or trust). As a result, the total business income that will generally be eligible for the QBI deduction will be between $2.0 and $2.5 million depending on filing status.

Lastly, the **corporate tax rate** is proposed to increase to **26.5%** (rather than 28% per the Biden proposal).

Transfer Tax Changes

The sunset of the applicable estate, gift, and generation skipping transfer (GST) tax exemption amount (currently $11.7 million per person) would occur in **2022** rather than 2026 as currently scheduled. The new level would therefore be approximately **$6 million** per person starting next year.

A somewhat surprising addition on the transfer tax front is a provision that **eliminates the effectiveness of grantor trusts for estate planning purposes**. Mirroring a proposal in Bernie Sanders's wholesale revision of the estate and gift tax rules, such trusts have formed the bedrock of wealth planning arrangements in recent years. Additionally, the new rule would trigger gain recognition on sales between a grantor and a grantor trust. The rule change would be effective for trusts created after 2021, as well as to transfers to existing trusts (notably, the bill does not address the obvious concern of the potential impact on life insurance trust planning (both new and pre-existing)).

Additionally, provisions aimed at **eliminating the use of valuation discounts** in many family wealth planning contexts was likewise included in the draft legislation, though normal discounting will still generally be available in the context of family-owned businesses and farms.

Notably absent from the proposal was an elimination of the step-up in basis that has been widely discussed in recent months. ***As a result of these proposals, the use of excess lifetime gift exemption, as well as the establishment and funding of a grantor trust prior to year-end, have likely taken on increased immediacy.***

Notably Absent from Draft Legislation

While many changes to the legislation are expected, notably absent from the initial draft were several widely discussed items including:

- State and local income tax (SALT) deduction relief (i.e., an increase from the current $10,000 limit);
- Limits on the tax deferral available under §1031 like-kind exchanges;
- Limits on the duration of GST exempt "dynasty" trusts; and

- Changes to the taxation of carried interest (though a 5-year holding period has been applied to extend the current 3-year requirement for capital gains treatment).

Many more developments are expected over the coming weeks.