LET THE TAX INCREASE GAMES BEGIN — The Ways and Means Committee's Initial Proposal for Revenue-Raisers to Pay for the Build Back Better Act

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THE PARTNERS GROUP

On September 13, 2021 the House Ways and Means Committee released its initial draft of proposed statutory language for tax increases of the Build Back Better Act that Democrats are determined to pass this year. Below is a brief description of various tax increases from this draft that could affect affluent individuals and businesses.

Please note the information below is only a summary of certain items from the House Ways and Means Committee's initial draft proposal and the Senate has not released its version of any proposed tax increases which could differ. Accordingly, this information is fluid and could change within days and the outcome of final legislation that is ultimately signed into law by the President, if any, is uncertain at this point. Despite this uncertainty, the House's initial draft helps provide insight into the types of tax increases that may get included in an upcoming budget reconciliation package.

Download a **summary** from the Ways and Means Committee of all its initial proposed tax increases and changes. Download an **additional explanation** of the proposed tax provisions from the House Budget Committee released on September 28, 2021.

INDIVIDUAL INCOME TAXES

Increase top marginal individual income tax rate to 39.6% for married individuals filing jointly with taxable income over $450,000, heads of households with taxable income over $425,000, unmarried individuals with taxable income over $400,000 and married individuals filing separately with $225,000.

- **Effective date:** Taxable years beginning after 12/31/2021.

Add a new tax code section, IRC § 1A, to impose a surcharge tax equal to 3% of a taxpayer's Modified Adjusted Gross Income (MAGI) in excess of $5,000,000 or $2,500,000 for a married individual filing separately. MAGI, for this purpose, means AGI reduced by any investment interest deduction under IRC § 163(d).

- **Effective date:** Taxable years beginning after 12/31/2021.

Increase the top long-term capital gains tax rate to 25%, adding up to 28.8% if the 3.8% Net Investment Income Tax (NIIT) applies and 31.8% if the proposed 3% surcharge tax mentioned above applies.

- **Effective date:** Gains and losses recognized on or after 9/13/2021, except those arising from transactions entered into pursuant to a written binding contract prior to 9/13/2021 to which the preexisting 20% rate continues to apply (before considering the NIIT or proposed IRC § 1A).

Expand the Net Investment Income Tax of 3.8% to apply to net investment income derived in the ordinary course of a trade or business for taxpayers with more than $400,000 in taxable income (single filer) or $500,000 (joint filer), as well as for trusts and estates.

- **Effective date:** Taxable years beginning after 12/31/2021.

Some planning insights and considerations to discuss with a financial, tax or legal professional:

- Accelerate ordinary taxable income, not capital gain income, in 2021 to pay tax the current, lower rate.
- Defer deductions until, and bunch charitable deductions in, 2022 to gain a great resulting tax benefit.
- Explore income-smoothing techniques to spread taxable income across multiple years to keep taxable income below the thresholds at which higher tax rates or surcharges apply.
- In the case of trusts and estates, distribute income to beneficiaries who may be subject to lower marginal tax rates and brackets.
- If capital gain assets need to be sold to fund short-term needs, consider borrowing against the asset instead, if possible, or offsetting capital gains with capital losses.
- Use tax-deferral strategies for 2022 and beyond to defer the higher taxes on employment income, such as qualified plans and non-qualified deferred compensation, where feasible.
- Use cash value life insurance as a means by which to accumulate wealth tax-efficiently in anticipation of higher taxes on traditional investment income.

INDIVIDUAL TRANSFER TAXES

Terminate the temporary increase in the lifetime estate and gift tax exclusion amount, reverting it to its 2010 level of $5,000,000 per individual indexed for inflation.

- **Effective date:** Estates of individuals dying and gifts made after 12/31/2021 – The lifetime exclusion amount would reduce to $6,030,000 in 2022.

Amend IRC § 2031 to eliminate valuation discounts for estate and gift tax purposes for transfers of entity interests with respect to any underlying nonbusiness, passive assets held to produce income except those used in hedging transactions or as working capital for the active conduct of a trade or business.

- **Effective date:** Transfers after the date of enactment.

Some planning insights and considerations to discuss with a financial, tax or legal professional:

- Make large gifts to beneficiaries, or a trust for their benefit, and allocate the increased estate and gift tax exclusion amount before the end of 2021 to remove larger amounts of wealth from the grantor's future gross estate.
- Going forward, review the tax and valuation implications of how business interests and other assets are owned within FLLCs and other family-controlled passive entities.

IRREVOCABLE GRANTOR TRUSTS

Add a new tax code section, IRC § 2901, to include in a deceased individual's gross estate any portion of an irrevocable grantor trust for which such person is the deemed owner for income tax purposes under IRC §§ 671-679, to treat distributions from such portion or such trust to anyone other than the deemed owner or deemed owner's spouse as a transfer by gift, and to treat all assets attributable to such portion as a transfer by gift at the time the deemed owner ceases to be treated as the owner of such portion during life. Proper adjustments are to be made to amounts so included in the gross estate, or treated as transferred by gift, under the forgoing to account for amounts previously transfer by the deemed owner to the trust that were treated as taxable gifts, e.g. a reduction equal to the amount of a prior taxable gift to the trust to prevent double inclusion and taxation.

- **Effective date:** An irrevocable grantor trust created on or after the date of enactment or any portion of preexisting such trust attributable to a "contribution" made on or after enactment.

Add a new tax code section, IRC § 1062, to treat sales of property between grantor trusts and their deemed owners as equivalent to sales between the grantor and a third party, essentially causing recognition of income on the transaction.

- **Effective date:** Any sale or disposition that occurs on or after the date of enactment between an irrevocable grantor trust and its deemed owner regardless of when the trust was created.

Some planning insights and considerations to discuss with a financial, tax or legal professional:

- To lock in the income and estate tax benefits of irrevocable grantor trusts, establish such a trust as soon as possible and fully fund it with the maximum gift possible prior to enactment of proposed tax law changes.
- Designate the grantor's spouse as a beneficiary of the grantor trust created and funded prior to enactment to preserve the ability to indirectly access the trust assets in the future, if needed, while the spouse is living.
- If "contributions" will be made to the trust after enactment it should be set up as a non-grantor trust; and the ability to distribute or appoint assets from a non-grantor trust to the grantor's spouse, if desired, may require approval by an "adverse party," such as the other trust beneficiaries.
- Future transfers to a grantor trust created prior to enactment may need to be done using properly structured loans or installment sales to avoid making new "contributions."
- If it is desired to use trust income to fund premiums on a life insurance policy insuring the grantor or grantor's spouse, the trust and related gifts of the assets that will produce income should be set up and completed before enactment since such an Irrevocable Life Insurance Trust (ILIT) would be a grantor trust.
- If ongoing transfers to an ILIT-grantor trust created before enactment are required to fund ongoing premium, the premiums could be funded by properly structured split-dollar loans after enactment to avoid making new "contributions" (existing policies should be reviewed to determine if they can be optimally funded in this manner).
- ILITs created, or to which "contributions" will be made, after enactment should be set up as non-grantor trusts and funded through gifts of cash only for the payment of premiums to avoid using any trust income for such purpose.
- Alternatively, it may be possible to set up a Family Limited Liability Company (FLLC), interests in which can be gifted to children or a trust for their benefit, to own the policy and keep a pro-rata portion of the death benefit out of the parent-insured's gross estate based on his or her pro-rata ownership in the entity.
- Review any outstanding loans, installment obligations or annuity arrangements between an irrevocable grantor trust and the deemed owner for alternatives to making payments in kind with appreciated assets after enactment.
- Carefully consider exercising powers of substitution, or other transactions, after enactment between an irrevocable grantor trust and the deemed owner with respect to appreciated assets.

RETIREMENT PLANS AND INDIVIDUAL RETIREMENT ACCOUNTS

Prohibit further contributions to a Roth or traditional IRA for a taxable year if the total value of an individual's IRA and defined contribution retirement accounts generally exceed $10,000,000 as of the end of the prior taxable year. This limitation applies only to single or married filing separately taxpayers with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000 and heads of households with taxable income over $425,000 (all indexed for inflation).

- **Effective date:** Taxable years beginning after 12/31/2021.

Impose a new account balance-based Required Minimum Distribution (RMD) from an individual's traditional IRA, Roth IRA and defined contribution retirement account. For taxpayers with the income in excess of the thresholds mentioned above regarding contribution limitations (e.g. $450,000 for married filing jointly), if the combined value of the individual's accounts exceeds $10,000,000 at the end of a taxable year, a minimum distribution is required equal to 50% of the amount in excess of $10,000,000 as of the end of the prior taxable year. For those with combined account balances exceeding $20,000,000, that excess is required to be distributed from Roth IRAs and designated Roth accounts in defined contribution plans up to the lesser of (1) the amount needed to bring the total balance in all accounts downs to $20,000,000 or (2) the aggregate balance in the Roth IRAs and designated Roth accounts in defined contribution plans.

- **Effective date:** Taxable years beginning after 12/31/2021.

Eliminate so-called "back-door" Roth IRA strategies by prohibiting Roth conversions for both IRAs and employer-sponsored plans for single and married filing separately taxpayers with taxable income over $400,000, marring filing jointly taxpayers with taxable income over $450,000 and heads of households with taxable income over $425,000 (all indexed for inflation).

- **Effective date:** Distributions, transfers and contributions made in taxable years beginning after 12/31/2031. Note the year of the effective date is not until 2031.

Prohibit all employee after-tax contributions in qualified plans and IRAs from being converted to a Roth regardless of income level.

- **Effective date:** Distributions, transfers and contributions made in taxable years beginning after 12/31/2021.

Some planning insights and considerations to discuss with a financial, tax or legal professional:

- Review income smoothing strategies or other options to reduce taxable income below the thresholds necessary to continue to be able to contribute to IRAs.
- Convert traditional IRAs and defined contribution plan accounts to a Roth before 12/31/2031 if income is expected to exceed the above thresholds.
- If the above account balance-based RMD provisions are enacted, use the distribution proceeds to acquire and fund a life insurance policy to help transfer wealth to beneficiaries, or grow cash value, tax efficiently.

CORPORATE AND BUSINESS TAXES

Replace the flat corporate tax rate structure with a graduated rate structure consisting of an 18% rate on the first $400,000 of income, 21% on income thereafter up to $5,000,000, and 26.5% on income thereafter. The benefit of the graduated rate phases out for corporations making more than $10,000,000 whereby those with income of $20,000,000 or more are effectively subject to a flat tax rate of 26.5%. Personal services corporations are not eligible for the graduated rates and are subject to a flat tax rate of 26.5%.

- **Effective date:** Taxable years beginning after 12/31/2021.

Limit the IRC § 199A Qualified Business Income (QBI) deduction to a maximum of $500,000 in the case of a joint return, $400,000 for an individual return, $250,000 for a married individual filing a separate return and $10,000 for a trust or estate.

- **Effective date:** Taxable years beginning after 12/31/2021.

Deny a charitable income tax deduction for contributions to conservation easements by partnership and other pass-through entities if the amount of the contribution (and therefore the deduction) exceeds 2.5 times the sum of each partner's adjusted basis in the partnership that relates to the donated property. This general disallowance rule, designed to curb syndicated conservation easement tax shelters, does not apply to donations of property that meet the requirements of the 3-year holding period rule, and contributions by family partnerships.

- **Effective date:** Contributions made after 12/23/2016 (the date of the relevant IRS Notice). For contributions of easements related to the preservation of certified historic structures – contributions made in taxable years beginning after 12/31/2018.

Some planning insights and considerations to discuss with a financial, tax or legal professional:

- Review the legal formation of business entities for tax purposes and determine if it will continue to remain the most suitable to meet business and personal needs.
- To the extent of any current or prior participation in syndicated conservation easements, seek tax and legal advice regarding whether the new deduction disallowance rule may apply retroactively or prospectively.