TTAA Legislative Update

October 4, 2021

Tax Update

<u>The portion of the reconciliation bill passed by the House Ways and Means Committee on September 15th includes a lot of new tax provisions. Among them, are some significant taxes on pass-through entities and small business owners. Despite the mantra of "tax the rich," at least some of these provisions will hit a number of small business owners, many of whom would not be typically be considered rich, particularly hard.</u>

In this update we will focus on the individual tax provisions coming out of the Ways and Means Committee.

One bright spot is that the Ways and Means Committee's provisions do not eliminate the step up in basis for assets going through an estate. This proposal, advanced by the Administration, would have destroyed many small businesses and hit many middle and upper middle-class taxpayers with a new capital gains tax. Unfortunately, it is too early to assume that we won't see this provision surface again as the reconciliation bill (recall this type of bill only requires a simple majority of votes in the Senate) is finalized in the House and potentially subject to modifications in the Senate. If the Senate and the House pass different versions of the reconciliation bill, then it is conceivable that even if this provision was not included in either version, it could still emerge during the conference committee where the differences between the versions are ironed out. Some think that, because this provision is one of the most controversial, it will be introduced at the last hour to shelter Democratic members of Congress from the avalanche of criticism sure to follow.

An important thing to recognize is that, under the Ways and Means provisions, by and large, few income taxes will rise for those with incomes less than $400,000. While in most areas of the country this is a significant amount of income, people with this level of income who live in many major cities are not considered wealthy, in fact they are considered upper middle class. Thus, though many Democrats in Congress believe this bill would only tax the "rich," there are many taxpayers and particularly, small business owners, who live in these cities and the surrounding suburbs who recognize that this bill could negatively impact them though they do not consider themselves "rich" by any means. Unfortunately, since the provisions passed by Ways and Means would increase taxes for many of the small businesses and owners in these cities and suburbs, there is a real risk that the tax hit will ripple down and could hurt the employees of these businesses as well as the community as a whole.

The Ways and Means provisions include no fix to the current limit of $10,000 for state and local income and property taxes ("SALT") which many Democrats want included in the reconciliation bill. This limitation hurt the taxpayers in blue states such as California, Maryland, New York, New Jersey, and Connecticut where property, state and local taxes are high. Many Democrats from these states are saying they will not vote for the bill unless something is done to reverse this unpopular limitation. Rumors continue to abound that the fix included might only apply to taxpayers with income below the $400,000 limit, or the limitation will be eliminated but only for a 2 year period (though the limitation is set to expire at the end of 2025 in any event) or that the $10,000 limit will be increased by a somewhat modest amount, say up to $40,000.

Here's a brief breakdown of some of the major provisions affecting individuals recently passed by the Ways and Means Committee:

·The new top marginal tax rate will be increased to 39.6% on taxable income over $400,000 for a single taxpayer, $450,000 for married individuals filing jointly and $13,000 for trusts and estates. This provision would be effective January 1, 2022.

·The capital gains and dividend tax rates would rise to 25% for those individuals, trusts and estates with taxable income at the top taxable rate. This provision is to be effective for sales occurring or dividends received on or after September 13, 2021.

·The 3.8% net investment income tax will be imposed on income not otherwise taxed as dividends, capital gains, or wages for persons with income greater than $400,000 for single taxpayers, $500,000 for married individuals filing jointly and all trusts and estates (no threshold). This provision is to be effective January 1, 2022.

·The maximum allowable deduction for the 199A deduction for pass through entities would be available only for single taxpayers making $400,000 or less, $500,000 or less for married individuals filing jointly and $10,000 or less for trusts and estates. This provision would be effective January 1, 2022. Even though the valuable 199A 20% deduction from income for pass-through entities was slated to expire as of January 1, 2026, the Ways and Means changes to the 199A deduction would mean that those pass-through entities that are more successful will lose this deduction come January 1, 2022. The original purpose of Section 199A was to try to give pass-through entities more tax rate parity with C corporations. If the Ways and Means provision were to become enacted into law as currently drafted (which is by no means a given), many pass-throughs would be at a major disadvantage and would seriously have to consider changing their organizational structure simply because of taxes. This would cause needless and wasteful business disruption and fees to advisors.

·A new 3% surcharge would be imposed on all income for either single or joint individuals having more than $5 million of income, or more than $2.5 million for married individuals filing separately or more than $100,000 of income for trusts and estates. This provision would be effective January 1, 2022.

·Effective January 1, 2022, the gift and estate tax exemption would be reduced to approximately $6 million per individual (*i.e.*, this would repeal the 2017 increase in the deduction four years earlier than slated under existing law). While some consider it good news that the federal estate tax exemption in January 1, 2022 will only revert to the amount that was slated to be in force come January 1, 2026 and not be reduced even more, many small business owners do not consider this to be good news. As in the past, these small businesses will be forced to spend wasted dollars on advisors to figure out how their businesses can best survive the deaths of the owners.

·Effective on or after the date of enactment, assets in a grantor trust would be taxed in the grantor's estate and distributions from a grantor trust would be taxed as a gift unless already reported as such. This provision would apply to any new grantor trusts created after the effective date OR to additions made after the effective date to a previously existing trust. This provision is extremely controversial inasmuch as it could immediately affect many trusts in existence and, at this juncture, it's not even clear how it would actually work. Many think this would mean that a standard irrevocable insurance trust where premiums are generally paid annually into the trust would trigger these new provisions. The amount of work that would result in trying to "fix" existing trusts, particularly those that are irrevocable, is staggering. Look for this provision to drop out until it is fleshed out more and the upheaval to the insurance market is better understood.

·Effective after the date of enactment, current discounts used in valuing family limited partnerships, LLCs and other closely held interests on the transfer of nonbusiness assets (passive assets) would be eliminated.

·An $11.7 million estate tax valuation reduction at death for real estate used in a family farm or business which is included in the estate would be available effective January 1, 2022.

·For individuals with income of $400,000 or more, no additional contributions can be made if the value of all of the individual's IRAs, defined contribution accounts, and 403(b) accounts is greater than $10 million, effective January 1, 2022.

·Effective January 1, 2022, two new Required Minimum Distribution rules are applicable to large IRAs (traditional and/or Roth) – for IRAs in excess of $10 million, 50% of the excess over $10 million must be distributed – for IRAs in excess of $20 million, 100% of the excess must be distributed. These IRAs are now referred to on the Hill as "mega-IRAs."

·Taxpayers with more than $400,000 of income are not allowed to make conversions to Roth IRAs after December 31, 2031. This appears to be a revenue raiser in the bill in that it encourages conversions to Roths during the ten year budget window. No after-tax contributions to Roth IRAs (sometimes referred to as "back door" Roth conversions) will be allowed after December 31, 2021. No after-tax contributions will be allowed in qualified retirement plans after December 31, 2021.

·Starting January 1, 2022, IRAs will not be allowed to hold investments in an entity in which the owner has 50% or greater of a public security or, what will be much more likely, 10% or more of a nonmarketable security. An IRA can no longer invest in an entity in which the IRA owner is an officer. These types of investment must be divested by the IRA by December 31, 2023. Investments requiring a minimum level of assets, income or education are prohibited and IRAs must divest themselves of these types of investments also by December 31, 2023. This means that an IRA cannot purchase an interest in Private Equity investments after the end of this year (and if it does, it must be divested within 2 years). These are unprecedented restrictions on IRA investments with forced divestment within a period of time that is too short. It is likely that this will cause some major disruptions in the market. Further, there are thorny issues involving "interested parties" and "prohibited transactions" which if not changed could create a whole slew of problems for small businesses.

·Taxpayers with adjusted gross income in excess of $400,000 will no longer qualify for the special 75% and 100% exclusion rates for gains realized from Section 1202 stock – qualified small business stock.

What's Next?

The most typical next step is that once the House passes its version of the reconciliation bill, then the Senate Finance will start marking up their tax provisions. If this happens, then it is expected that the House and the Senate will end up with bills that have different provisions. Then either the House will have to pass the Senate's version of the bill or the two versions will go to the conference committee which will work out a compromise bill. The final bill will then go back to the House and the Senate (if changes are made from the Senate version) for final passage and then on to the President to be signed into law. Under this scenario, we could see different provisions emerge and the overall size of the final bill could end up far smaller than what may initially come out of the House. Senators Manchin (D-WV) and Sinema (D-AZ) are not in favor of a $3.5 trillion bill. However, what is not clear is whether, if the revenue raisers in the bill happened to exactly equal $3.5 trillion or even $3 trillion, either or both of the Senators would still consider it a $3.5 trillion bill? Thus, it is not clear how much we can read into their statements of opposition to the size of the bill. Both Senators who represent the moderate wing of the Democratic Party believe that the House bill is trying to establish too many costly new programs – in short biting off more than the country can chew. Of course, the progressive wing of the Democratic Party believes that the House bill does not go far enough. It is likely under this scenario, however, that the Senate will adopt a smaller bill with fewer new programs and fewer new tax provisions assuming either or both Senator Manchin or Senator Sinema stay firm in their opposition to a bill this large.

Recently, it looked as if the House was going to try to work with the Senate leadership and the White House to come up with a bill that would have sufficient votes in the Senate for the Senate to simply adopt it after it is passed by the House. However, unless a number of major amendments are made to the bill on the floor of the House during the vote supposedly coming up this week, then the Senate will not be in a position to pass the House bill as is and will be working on its own version.

As mentioned earlier, of concern is that the elimination of the step up in basis for assets going through an estate could surface at some later time in this process. The provisions most likely to be excised are the 3% surcharge tax on more than $100,000 of trust income and some or all of the grantor trust changes, particularly those that could have serious ramifications to the insurance market. Of course, other provisions could be on the chopping box. Many in the retirement plan community are up in arms about the sudden prohibition of certain investments in IRAs and the short period to divest these investments which will cause disruption in the market place.

As things develop, we will be reporting back to you.

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