SCWA Legislative Update

March 8, 2021

Senate Passes American Rescue Plan Act Of 2021 With Amendments

The Senate passed the $1.9 trillion COVID-19 relief bill by a vote of 50-49 on Saturday, after debating numerous amendments over the previous day.

Six amendments were adopted, one of which was a bi-partisan change, offered by Senators Jerry Moran (R-KS) and Richard Blumenthal (D-CT), to eliminate the vexing 90/10 rule from the VA education program.

As a result of the Senate substituting its own measure for the House bill (H.R. 1319), the Senate must send their bill to the House for approval. If passed, President Biden has already indicated he will sign it.

House leaders have agreed to vote on the Senate bill Tuesday, despite vocal objections to the minimum wage increase being dropped, and the Federal unemployment benefit reduced from $400 per week to $300 per week through Sep 6th.

The House is narrowly divided, 221 Democrats and 211 Republicans, thus the vote there will be close. If the House passes the Senate amendment, the bill will go to the President who is expected to sign it before March 14th when Federal unemployment benefits expire.

Are New Taxes Likely in 2021?

This is a key question that small business owners are closely monitoring as the new Biden Administration continues to settle in after their first month in office. As of today, no significant legislation which would increase taxes has yet to gain any momentum in the House or Senate. However, during the campaign President Biden proposed a number of new taxes and changes to the tax code. Some believe that at least some of his tax plan will be included in a second budget reconciliation bill. Even though at least some are convinced that a second reconciliation bill would be used to increase taxes (as outlined below), others believe it may be used

for infrastructure only or a combination of both increased taxes and new spending for infrastructure.

The argument against raising taxes this year is while the country is in a recession and the new COVID stimulus bill is likely to stimulate our economy it makes no sense to pass a major tax bill, including a significant tax increase to corporations, which would have a depressive impact on our economy. While our deficit is significant, the cost of borrowing remains low so a strong argument can be made that it is more important to get out of the recession and get people back to work first. Increasing taxes on the corporations at a time when they would hopefully be responsible for a good deal of needed reemployment of their employees does not seem to make sense.

Of course, only a simple majority is needed to pass a major tax and/or infrastructure bill in the Senate when it is passed through the reconciliation process. The most significant tax items that we see possibly emerging in a second reconciliation bill which is likely to be passed sometime in the fall, are the following:

•The elimination of many of the tax cuts passed in the Tax Cuts and Jobs Act for individuals making more than $400,000. This was the centerpiece of the President's tax plan set forth during his campaign. For example, many taxpayers who were in the 35% or 37% tax brackets would find themselves in the 39.6% bracket.

•The elimination or limitation of Section 199A which provides a 20% deduction for pass-through entities for taxpayers with income over $400,000. Unfortunately, this valuable deduction for many small businesses and privately owned businesses that operate as pass-through entities (e.g., partnerships, Sub-S corporations, LLCs that are taxed as partnerships, sole proprietorships) will already automatically terminate at the end of 2025 under the Tax Cuts and Jobs Act.

•Limiting the value of itemized deductions to 28% - in other words those in higher income tax brackets would not be able to receive the full value of their deductions. Also, the so-called "Pease Limitations" would be brought back into the law for those taxpayers with income over $400,000. The concept behind these limitations would be to even the playing field between high- and low-income taxpayers so that someone in the 28% tax bracket would be receiving the same value deduction as an individual in the 37% (or higher) tax bracket. It is possible that the $10,000 SALT (state and local tax) deduction limitation enacted by the Tax Cuts and Jobs Act would be repealed, but the impact of the repeal would be offset somewhat by the above limitations on the value of deductions.

•The elimination of the deduction of 401(k) and IRA contributions from income but instead a credit equal to the amount of the contribution multiplied by a fixed percentage (possibly 26%) would be available. This proposal has been met with a real lack of enthusiasm on the Hill and particularly by those members of Congress who are most knowledgeable of the retirement plan system. Many retirement plan

experts question how this proposal would even work – it would seem that all contributions made after the change from a deduction to a credit would have to be tracked separately and new accounts established since people in higher income tax brackets would have effectively paid income tax on a portion of their contributions. This means they would have established some "basis" in their accounts which at least theoretically should not be subject to income tax when distributed from the retirement plan or the IRA. If an enacted version of this proposal were to end up subjecting a portion of the contributions to double taxation, it is likely that this could reduce future contributions to 401(k) plans and IRAs, thereby adversely affecting the retirement plan security of millions of Americans.

•The elimination of the step up in basis at death. Today when assets go through an estate, they receive a step up in basis to the then fair market value. For instance, if a decedent had a basis of $100,000 in his personal residence which had a fair market value of $600,000 at the time of death, then under current law his heir(s) would inherit the property with a basis of $600,000. If the heir(s) then sold the house, there would be no capital gains tax. Under this proposal, the heir(s) would now have $500,000 of capital gains. This would be a brand-new tax and it is irrelevant whether the heir has income above or below $400,000. This provision has not been fleshed out so it is not clear whether death would be an event triggering capital gains, or the recognition of capital gains would occur at a later time when the asset was sold. It is also not clear whether a certain amount of gain would be exempt from this provision and/or whether certain assets such as a portion of a personal residence would be exempt. When this proposal was unsuccessfully advanced by the Obama administration, it was structured so that capital gains due on a small business would be deferred until the business was sold (under that provision the tax was otherwise triggered by death). When former President Trump advanced his proposal while he was running for the presidency back in 2016, it appeared that he would have exempted $10 million of capital gains – though this provision on his website was garbled so that some thought his proposal was that people with assets below $10 million would be exempt rather than $10 million of gain.

Even though this change is portrayed by its supporters as closing a huge loophole for the rich, the reality is that if the step up in basis were to be eliminated, it would generate a major new capital gains tax for millions of Americans, including those who are in the middle or lower-middle income class. For example, and as explained above, the heir(s) of an older individual who has lived in the same house (which has greatly appreciated and has a very low basis) for 60 – 70 years is likely to end up with a significant amount of capital gains tax. Without this new tax, this same individual's estate and his/her heir(s) would have paid NO tax.

•For individuals with more than $1 million (or a lower amount – perhaps $400,000!) in taxable income, long term capital gains rates and qualified dividends would be subject to ordinary income tax rates, rather than the current 20% preferred rate on capital gains.

•The top corporate rate would increase from 21% to 28%. The reduced 21% rate came in the Tax Cuts and Jobs Act. Many felt that this reduction was too extreme and that an increase is necessary to raise needed revenue. The Section 199A deduction was enacted in order to keep some sort of parity between the rates charged a pass-through entity with that charged a C Corporation. The 199A 20% deduction provides a marginal tax rate of 29.6%. A new minimum 15% tax on corporations with at least $100 million in revenue could also be included.

•The reduction of the current federal estate tax exemption from $11.7 million to $5.85 million immediately rather than waiting for the automatic reduction which would occur at the end of 2025 under the Tax Cuts and Jobs Act. It is possible that the estate tax rate, currently at 40%, could also be increased to 45% or even higher for larger estates.

•The elimination of NOL carrybacks and the elimination or limitation of like-kind exchanges under Internal Revenue Code Section 1031.

•An expanded Social Security payroll tax would subject wages above $400,000 to the 6.2% Social Security payroll tax (this would also be true for self-employment income over $400,000). In practice this would mean that for an individual making over $400,000, income up to $142,800 would be subject to the normal 6.2% payroll tax and then the 6.2% payroll tax would start up again on all income over $400,000. What is not discussed at all with this new proposed payroll tax for individuals with income over $400,000 is the cost of this proposal for employers who presumably would have to match the 6.2% on the additional income (income over $400,000) subject to the payroll tax. But note a change in Social Security cannot be accomplished in a reconciliation bill.

•The possible repeal of fossil fuel tax preferences.

There may also be some positive changes:

•An increase in the child tax credit is expected. There may be some relief with student loans and/or a credit for first time home buyers.

•Perhaps the SECURE Act 2.0 provisions would be included in this bill.

•New or expanded tax credits to encourage manufacturing and renewable energy or other provisions which would protect against climate change could be included. Additional relief for small business might also be included.

A few points – if a tax bill were to be enacted this year, many tax experts believe that the effective date of the legislation would be retroactive to January 1, 2021. Even though it is constitutional to enact retroactive tax legislation, it seems unlikely that there would be a retroactive effective date given the 50-50 split in the Senate. It is far more likely that the bill would have an effective date of January 1, 2022 or at least no earlier than the date of enactment or conceivably the date the legislation is first introduced.

More importantly, given the 50-50 Senate, in order to pass any of the provisions

listed above, either all of the Democrats would have to vote for the legislation, or some Republicans would have to do so. It is clear that Senator Joe Manchin (D-WV) and Senator Kyrsten Sinema (D-AZ) have already established that they are going to hold to a centrist position. Senator Manchin is well known for his support of small business and is extremely knowledgeable on sophisticated tax issues. Thus, he is not someone who will be swayed by a 30 second soundbite but would instead understand the real impact of a tax change on his constituents.

If either or both Senators Manchin and Sinema (or other Democrat Senators) were to vote against a bill that eliminated the step up in basis and the reduction in the federal estate tax exemption, how likely is it that Senator Susan Collins (R-ME), Senator Lisa Murkowski (R-AK), Senator Mitt Romney (R-UT) or other Republican Senators would vote in favor of the bill? Given this dynamic, it may be that many of these provisions will not be included in any tax legislation until at least 2023.

On the other hand, given the extraordinary level of our national debt, it would seem that at some point members of Congress are going to have to get serious about reducing the deficit and try to balance the budget. One could argue that no one has been serious about reducing our debt for the last many years, so why start now, but the numbers are becoming so significant and so outside of historical norms that Congress may finally have to deal with it. Nevertheless, given our current recession this would not seem to be the year for attempting to reduce the deficit.

Finally, be watching the IRS closely to see what new regulations are being developed. Most tax experts fully expect a flood of new regulations over the next four years.