House Releases Tax Change Proposals

Includes many of President Biden's campaign promises to raise taxes on high earners

Higher income tax rates on individuals & corporations, lower estate tax exemptions, expanded child credits and changes to retirement plan distributions highlight the proposal.

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As part of a multi-step budgetary process, the House of Representatives released portions of their version of a reconciliation bill. This legislation would be part of the "Build Back Better Act", a companion to the fiscal year 2022 federal budget. While there is still significant work to be done – and challenges to overcome – before any of this becomes law, we now have a better idea of what might make its way into a final bill.

As President Biden promised during his presidential campaign last year, the proposal includes higher tax rates on ordinary income and on capital gains and dividends for couples with income over $450,000, as well as higher tax rates on corporations. And as expected, there are also significant proposed changes to the estate tax system, although these proposals are substantially different than what was included in the Treasury Department's Green Book released in May. Also included are rules that would impact retirement savings for the very wealthy by prohibiting some types of contributions and even forcing withdrawals from retirement accounts that exceed $10 million. Much of the revenue raised by these changes would fund various forms of infrastructure spending, but would also support a continuation – and expansion – of various credits and incentives that were introduced during the pandemic.

What's almost as interesting as what the House did include is what was left out of their proposal. A capital gain tax rate increase was included, but not nearly as significant, or as back-dated, as was suggested earlier. The earlier proposals to change the basis step-up rules and make gifts of appreciated assets a taxable event were also left out, perhaps a sign that those changes faced a difficult road to passage. Adjustments to the deduction for state and local taxes – the SALT deduction – were also left out.

Excluding those items doesn't necessarily ensure the rest of the bill becomes law. The Senate is working on their own version of a bill that is expected to include additional tax changes, and the two versions would then need to be reconciled into one. There is also the requirement among some members of Congress to simultaneously pass a second bill, focused on hard infrastructure. Democrats hold incredibly tight margins in both the House and Senate, and with no Republicans expected to support any tax or spending bill, finding something that can pass with near-unanimous Democratic support will be challenging. Washington will be very active over the next several weeks.

The following are some of the key tax and planning provisions included in this House proposal.

HIGHER TAX RATES ON INDIVIDUALS

President Biden and others have been pushing to increase the top marginal tax rate on individuals to 39.6%, and the House proposal follows through on that goal. The House also proposed lowering the income level at which the 35% tax rate applies, meaning any married couple with taxable income above $400,000 (or any single above $200,000) would see that income taxed at a higher rate.

Married Filing Joint	Tax Rate	
Taxable Income	**2021**	**Proposed 2022**
$0 – 19,900	10%	10%
$19,900 – 81,050	12%	12%
$81,050 – 172,750	22%	22%
$172,750 – 329,850	24%	24%
$329,850 – 400,000	32%	32%
$400,000 – 418,850		35%
$418,850 – 450,000	35%	
$450,000 – 628,300		39.6%
$628,300 +	37%	

Single	Tax Rates	
Taxable Income	**2021**	**Proposed 2022**
$0 – 9,950	10%	10%
$9,950 – 40,525	12%	12%
$40,525 – 86,375	22%	22%
$86,375 – 164,925	24%	24%
$164,925 – 200,000	32%	32%
$200,000 – 209,425		35%
$209,425 – 400,000	35%	
$400,000 – 523,600		39.6%
$523,600+	37%	

The 39.6% rate would also apply to estates and trusts with income over $12,500, a level that is currently taxed at 35-37%. These new rates would be effective beginning in 2022.

Taxpayers who would be affected by these higher rates in 2022 should look to accelerate income from 2022 into 2021, although that's often easier said than done. Executives with stock options expiring in 2022 may wish to exercise them in 2021. Individuals turning 72 in 2021 can delay their first RMD to as late as April 1, 2022 but should consider taking that withdrawal this year. Other IRA withdrawals, including a Roth conversion, may be less costly if done in 2021 rather than next year, while business owners should look to accelerate billings to ensure collections this year. Conversely, deductible expenses may be more valuable by deferring them to 2022, when they can offset income taxed at higher rates. This would include charitable contributions as well as expenses incurred by business owners.

INCREASED TAXES ON CAPITAL GAINS

Like the changes to the ordinary tax rates, taxes on capital gains and qualified dividends would also increase for married couples with income over $450,000 and singles with income over $400,000.

Married Filing Joint	Current	Proposed
$0 – 80,800	0%	0%
$80,800 – 450,000	15%	15%
$450,000 – 501,600		25%
$501,600 +	20%	

Single	Current	Proposed
$0 – 40,400	0%	0%
$40,400 – 400,000	15%	15%
$400,000 – 445,850		25%
$445,850 +	20%	

This higher rate would also apply to estates and trusts with income over $12,500.

A significant difference in this case, however, is that the new rates would apply to any capital gains realized after September 13, 2021. Gains realized that day or earlier will be subject to the lower 15% or 20% rate, as would gains tied to a binding written contract entered into by that date and not materially changed afterwards.

While this proposed 25% rate isn't as high as the 39.6% that had been suggested earlier, and the effective date is later than had been anticipated, it still leaves taxpayers with little opportunity to plan around the change. Taxpayers already over the applicable income thresholds this year may want to reconsider recognizing gains until perhaps 2022 if they can fall back below those levels. Those below the threshold should be careful about recognizing additional non-capital gain income, as that income can cause gains realized later this year to be subject to the new higher bracket. On the other hand, capital losses can become more valuable if they are used to offset gains taxed at those higher rates. As always, though, decisions to sell a security should be based primarily on the investment merits of the position, with taxes being a secondary concern.

HIGH-INCOME TAXPAYER SURCHARGE

In addition to these changes to the individual tax brackets, a new 3% surcharge would be applied to taxpayers with Modified Adjusted Gross Income (MAGI) above a specific threshold. Beginning in 2022, the surcharge would apply to married couples filing jointly with MAGI over $5 million, singles over $2.5 million and estates and trusts over $100,000. MAGI for purposes of this surcharge would equal adjusted gross income reduced by any otherwise deductible investment interest expense. Because this surcharge is based on MAGI, other “below the line” deductions such as charitable contributions or the qualified business income deduction can't be used to reduce its impact.

As with the higher marginal tax brackets, most taxpayers can only avoid this by avoiding recognizing income that pushes them over this threshold. Because the tax is based on all types of income, this would include things like Roth conversions or other retirement account withdrawals along with capital gains. Electing installment sale treatment on an asset sale, when available, can spread income over multiple years and help avoid exceeding the surcharge threshold.

NEW TAXES, LIMITS ON PASS-THROUGH BUSINESS OWNERS

The maximum benefit from the Qualified Business Income deduction, created as part of the TCJA in 2017, would be capped at $500,000 for couples filing jointly, $400,000 for singles and $10,000 for a trust or estate. This is not a change to the eligibility or phaseout rules, but simply a ceiling on the total QBI deduction claimed, and would apply regardless of the type of business or any other aspects of the taxpayer's situation. This would be effective beginning in 2022.

This proposal would also attempt to solve what is viewed as one of the bigger areas of abuse by some pass-through business owners. Income paid to these owners as salary and reported on a W-2 is subject to FICA and Medicare taxes, but income passed through via a K-1 is exempt from those taxes. As a result, some owners tend to pay themselves a small salary to avoid those taxes. This bill would make trade or business income subject to the 3.8% Net Investment Income Tax (NIIT), but only if that income has not been subject to employment taxes. This would primarily affect ordinary income reported on a K-1 by S Corporation shareholders, and would only apply for couples with taxable income above $450,000 or singles above $400,000.

Lastly, the proposal would make permanent the disallowance of excess business losses for non-corporate taxpayers (e.g., individuals, trusts), a rule that was schedule to expire after 2025. Excess business losses are those losses over $500,000 for couples and $250,000 for individuals. These excess losses would also no longer be treated as net operating loss carryovers in the future, but instead would be considered a deduction for the business in the following tax year. This provision would apply to any excess losses incurred after 2020.

CHANGES TO TAX RULES FOR C CORPORATIONS

In addition to the tax break for pass-through businesses, the 2017 TCJA also lowered the tax rate applied to C Corporations from 35% to 21%. President Biden has pushed to increase that rate to as high as 28%, and while the

House did address the corporate tax rate, they didn't go as high as the President wanted. Instead, these businesses would be subject to a bracketed tax system:

Taxable Income	Tax Rate
$0 – 400,000	18%
$400,000 - $5 million	21%
Over $5 million	26.5%

Businesses with taxable income between $10 million and roughly $14.7 million would also be subject to a 3% surcharge, which would gradually eliminate the benefit of the 18% and 21% brackets.

Among other changes affecting businesses would be a change in how they deduct executive compensation. Businesses are already prohibited from deducting more than $1 million in compensation for some executives, and that list was to be expanded beginning in 2027. This bill would accelerate that limitation to 2022.

NEW RULES FOR LARGE RETIREMENT ACCOUNT BALANCES

In light of recent news stories of individuals accumulating incredibly large retirement account balances – in some cases in the billions of dollars – it seemed likely that Congress would address these tax-sheltered investments. They've chosen to do so with a pair of strategies.

The first and most significant of the two would require high-income taxpayers to take distributions from retirement accounts when those account balances – in total – exceed a threshold value. Applicable accounts include 401(k), 403(b) and governmental 457 plans, plus any Traditional, Roth, SEP or Simple IRAs. These new distribution rules would begin in 2022 and would apply in any year an individual, who is married and files jointly, has taxable income above $450,000 or a single individual has taxable income over $400,000. For those with income above these thresholds, there are two tiers of distribution requirements:

- For those with total retirement account balances over $10 million (based on the value at the end of the preceding year), the taxpayer is required to withdraw 50% of that excess amount. For example:
  - An individual with income in 2022 of $500,000 has retirement accounts totaling $14 million as of December 31, 2021. That person has an excess balance of $4 million and would be required to withdraw $2 million of that amount in 2022, which can be taken from any of the included accounts.
- A separate rule applies to those with retirement account balances totaling more than $20 million, when part of that is in a Roth-type account (such as a Roth IRA or Roth 401k). In those cases, the taxpayer must withdraw enough of the Roth account to bring the remaining total balance to $20 million, and then withdraw 50% of the remaining balance over $10 million from any of the remaining accounts. For example:
  - An individual has $18 million in a 401(k) plan and $5 million in a Roth IRA, for a total balance of $23 million. They must first withdraw $3 million from the Roth account, enough to bring the total balance to $20 million. They must then withdraw another $5 million (50% of the remaining balance over $10 million), which can come from either the 401(k) or Roth account.
  - An individual has $21 million in a 401(k) plan and $5 million in a Roth IRA, for a total balance of $26 million. They must withdraw the entire $5 million from the Roth, leaving a balance of $21 million in the 401(k). They must then withdraw $5.5 million from the 401(k), 50% of the excess balance over $10 million.

These excess distributions would be required regardless of the age of the account owner. Distributions made under these rules by someone under age 59½ would be exempt from the 10% early withdrawal penalty, however.

The other proposal for those with large balances and high income would prohibit some additional contributions to those accounts. It would apply to those with income over the same levels as above, and only when account balances reach the same $10 million level. In that case, contributions to a Traditional or Roth IRA would be prohibited. Contributions to employer plans, as well as SEP and Simple IRAs, would still be allowed. However, those accounts would also be subject to the new large account withdrawal requirements, so 50% of those contributions would have to be withdrawn from the account the following year.

LIMITATIONS ON ROTH CONVERSIONS

In a further attempt to address those large retirement account balances, especially for Roth accounts, this proposal would make the following changes:

- Beginning in 2022, Roth conversions could only be made with amounts that would be considered taxable income. This means that any after-tax amount currently in an employer plan or a Traditional IRA would not be eligible for conversion. This provision would end the “backdoor Roth conversion” and “mega-backdoor Roth conversion” strategies that have become popular over the last decade. This proposal would not, however, prohibit after-tax or contributions to those plans, nor would it affect Roth contributions.
- This proposal would also prohibit Roth conversions entirely for any couples with taxable income over $450,000, or singles over $400,000. However, this change wouldn’t take effect until 2032, so there would be plenty of time to plan around this (or even for it to change again before it actually applies).

Based on these proposals, 2021 would be the last year to make an after-tax contribution to a retirement account (IRA or employer plan) and then convert it to a Roth. Those considering this transaction should be sure to complete the conversion before the end of 2021.

RULES AFFECTING INVESTMENTS IN IRAS

Two new rules would restrict the types of investments allowed in IRAs. Violation of these rules would result in the IRA losing its IRA status, meaning the value of the account would be fully taxable in the year of the violation.

- IRAs would be prohibited from owning any type of investment that is only offered to “accredited investors”, meaning people who meet certain minimum income, net worth or education standards. This would apply to purchases made after 2021, and accounts already holding those positions would have two years to transition out of them.
- Similarly, IRAs would be prohibited from owning investments in which the IRA owner has a “substantial interest”. This includes any entity where the IRA owner owns 10% or more of a company that is not publicly traded or any company where they are an officer, director or hold a similar position. This would apply to investments made after 2021, and would require accounts already holding these positions to sell them by the end of 2023.

ENHANCEMENTS TO THE CHILD TAX CREDIT

Earlier this year, changes were made to the child tax credit, increasing the credit amount and income phaseout ranges, while beginning an advanced monthly payment of that credit for 2021. This proposal would extend and enhance those provisions through 2025, as follows:

- The advance payments being made for 2021 equal 50% of the credit expected to be allowed. This would increase those advanced payment to 100% of the expected credit.
- Taxpayers would only have to provide uncompensated “care” for an eligible child, rather than providing more than 50% of their support.
- Eligibility for these credits in 2022 would be based on the lower of a taxpayer’s 2021 or 2022 modified adjusted gross income. For 2023-2025, eligibility would be based on the lowest income level for that year and the previous two years.

ENHANCING THE SOCIAL SAFETY NET

In addition to the child tax credit enhancements, this proposal includes several other provisions described as "Enhancements to the Social Safety Net":

- The child and dependent care credit would be expanded by increasing the amount of eligible expenses and the credit percentage. As a result, the maximum credit for one child would increase from $1,050 to $4,000, and from $2,100 to $8,000 for those with multiple children.
- The increased tax-free benefit for employer-provided dependent care ($10,500 for couples, increased from $5,000) would be made permanent, rather than expiring after this year.
- Individuals who provide care to a spouse or other relative who is certified to need long-term care would be eligible for a new tax credit. The credit is equal to 50% of up to $4,000 in qualified expenses and begins to phase out for caregivers with AGI over $75,000.
- The expanded eligibility for credits for health insurance premiums under the Affordable Care Act would be made permanent.
- A new credit would be available to blind individuals for expenses paid for qualified technology expenses, regardless of income level. The credit would equal 100% of up to $2,000 in expenses, and would apply for 2022 through 2026.

OTHER CHANGES AFFECTING INDIVIDUALS

- Some or all of the gain on the sale of qualified small business stock (known as 1202 gain) can currently be excluded from tax. For sales occurring after September 13, 2021, that exclusion is no longer available for an individual taxpayer (married or single) with AGI over $400,000, or for any trust. An exception is available for binding contracts entered into before that date.
- The constructive sale rules would be expanded to include digital assets, such as cryptocurrencies. This would treat as taxable any transaction that is intended to lock in investment gains without realizing a gain for tax purposes. This would apply to any transaction after the date this bill would be enacted.
- Beginning in 2022, digital assets (including cryptocurrencies), foreign currency and commodities would become subject to the wash sale rules, which restrict the ability to deduct a loss when a substantially identical position is also purchased.
- A new above-the-line deduction would be created allowing taxpayers to deduct up to $250 of dues paid to a labor union. This deduction would be available regardless of whether the taxpayer itemized their deductions or used the standard deduction.

REDUCTION IN THE ESTATE TAX EXEMPTION

Changes to the estate tax have long been anticipated to be part of any tax legislation passed this year, but the format of those changes has been uncertain. The most recent proposal from President Biden included major changes to the basis adjustment at death rules, but left the estate tax exemption at the current $11.7 million per taxpayer. The House proposal reversed that plan, leaving the basis adjustment rules in place, but accelerating the reduction in the exemption. Rather than letting the current high exemption expire after 2025, this proposal accelerates the reduction to 2022. The estate tax exemption in 2022 would return to the 2017 level, adjusted for inflation, meaning an amount of approximately $6 million.

Taxpayers with large estates have long considered how to plan around the future reduction in this exemption, but with the reduction potentially happening in just a few months, the need for planning has become more urgent. Gifts using the lifetime exemption this year reduce the estate tax exemption not only this year, but next year and beyond. Therefore, in order to take advantage of the portion of the exemption that is expiring, transfers this year must be more than what the exemption will fall to – meaning only transfers of more than $6 million this year would prove effective.

- Those with estates large enough to be subject to estate tax regardless of the exemption – roughly $25 million or more – should consider making transfers before year-end. Those with smaller estates might be more hesitant to commit to transfers that large, however.
- Another factor to consider is age. Older taxpayers may be more willing to make a large transfer, although they will have to weigh the estate tax benefits against the loss of a basis adjustment on assets excluded from their estate. Younger taxpayers may be more hesitant, though, wanting to be more confident their own needs are met before making a big transfer.

A common technique used in this environment is a Spousal Lifetime Access Trust (SLAT), which allows assets to move from one spouse to a trust for the other. This allows the other spouse restricted access to the funds, meaning the spouse who creates and funds the trust could benefit indirectly. Transfers can be made instead to a trust for the benefit of only children or grandchildren, but this arrangement may not be as flexible. Anyone thinking of planning around the current large estate exemption should reach out to their estate planning attorney as soon as possible. Those waiting until later in the year may find trusts cannot be created in time.

OTHER CHANGES AFFECTING ESTATE PLANNING

Intentionally Defective Grantor Trusts (IDGTs) – trusts that move assets out of an estate while keeping the income tax liability with the grantor, creating in effect another tax-free gift – would become ineffective under this proposal.

- The value of any such trust owned by the grantor at the time of their death would be included in their taxable estate.
- Meanwhile, any distributions from the trust to anyone other than the grantor would be considered a gift to that person, potentially subject to gift tax. If at any time the grantor is no longer considered the owner for tax purposes, the value of the trust would be considered gifted to the new owner.
- Any sale of assets to the IDGT would be considered a taxable sale, as opposed to being a tax-free transaction under today's rules.

These new rules would apply to any trust created after the enactment of these new laws, meaning trusts created prior to that date are exempt from the new rules. However, new contributions to existing trusts would be subject to the new rules, so it would be important to completely fund the trust before the new rules go into effect.

Other changes affecting estate planning include:

- Decedents who own real property used in a family farm or other family business are allowed to value property in the estate based on how it's actually used, not at what would be its fair market value. The maximum valuation discount allowed in these cases would be increased from $750,000 to $11.7 million.
- The use of valuation discounts when transferring passive assets and interests in family businesses owning passive assets would be eliminated, while preserving those discounts for active businesses. This would affect entities like Family Limited Partnerships which hold assets such as cash, stocks and bonds, collectibles and other personal property, real property, etc. This change would take effect after the date of enactment, meaning discounts claimed prior to that date would be preserved.