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Key takeaways from the House tax bill

Advanced Planning Group

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Overview of where we are in the process

- On September 13, 2021, the House Ways and Means Committee introduced its bill, which included a number of proposed tax changes.
- The Senate will introduce its own version of the bill, which will likely include some of the same proposed changes and additional proposed changes.
- If, as is likely, that the two separate bills are different, they must then be reconciled and ultimately agreed upon before the final bill lands on the President's desk for signature.
- While we wait on the drama that will undoubtedly unfold, one thing is clear: if enacted, taxes are going up in a myriad of ways for corporations and wealthier taxpayers.
- Effective Dates. Some changes are effective as of the date of introduction (September 13, 2021), some effective as of the date of enactment, while others are effective after December 31, 2021, or even later. Responding swiftly will be key for any planning as individuals may not even have until the end of the year for certain planning opportunities.

What does the bill include?

- **The bill contains a variety of changes across the tax code:**
  - IRS funding and compliance
  - Social safety net (child tax credit; credit for other dependents; child and dependent care credit; employer-provided dependent care assistance; earned income tax credit; premium tax credit; payroll tax credit; and caregiver expenses)
  - Individual tax reform
  - Estate tax planning:
    - Trusts and estates
    - Grantor trusts
    - Valuation rules
  - Retirement plan limits
  - Corporate and international reforms
  - Other select business reforms
  - Energy
  - And more…

- Our focus will be on the provisions that most directly affect individuals and estate tax planning.

Income and capital gains taxes

- **Individual income tax rates**
  - The top rate increases from 37% to 39.6%
  - Top bracket expanded to include:
    - 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
    - Married individuals filing separate returns with taxable income over $225,000
    - Estates and trusts with taxable income over $12,500
  - Applies to taxable years beginning after December 31, 2021.

- **Capital gains**
  - Top capital tax gains rate increased from 20% to 25% for taxpayers in the top bracket.
  - 25% rate effective beginning after September 13, 2021, unless a written binding contract had been entered into on or before September 13, 2021, with respect to such property.

Income and capital gains taxes

- **Net investment income tax**
  - Net investment income tax (NIIT) is a 3.8% tax currently imposed on interest, dividends, capital gains, rents and royalties, as well as several other categories of income for taxpayers meeting the income threshold.
  - The proposed bill expands the net investment income tax to cover income derived in the ordinary course of a trade or business for high income taxpayers.
  - Does not apply to income on which Federal Insurance Contributions Act (FICA) already applies (i.e., Social Security and Medicare taxes).
  - In many cases, this effectively pushes the top rate on capital gains to 28.8%.
  - Applies to taxable years beginning after December 31, 2021.

Income and capital gains taxes

- **Tax surcharge**
  - In addition to increased income and capital gain tax rates, high income individuals, trusts, and estates would be subject to an additional 3% tax on certain income.
  - The tax applies to modified adjusted gross income in excess of $100,000 for any trust or estate, $2.5 million for a married individual filing separately, and $5 million for any other taxpayer.
  - For an individual, trust or estate in the highest tax bracket, the effective rate may be as high as 46.4%:

39.6% tax bracket + 3.8% NIIT + 3% tax surcharge = 46.4%

  - Modified adjusted gross income is a taxpayer's income less certain adjustments, such as for contributions to retirement accounts and deductions for certain investment expenses.
  - Applies to taxable years beginning after December 31, 2021

Estate and gift tax exemptions

- The Tax Cuts and Jobs Act of 2017 (TCJA) doubled the estate and gift tax exclusion and the generation skipping tax (GST) exemption to a historic high of $10 million adjusted for inflation for decedents dying or gifts made between January 1, 2018, and December 31, 2025. In 2021, the estate and gift tax exclusion is $11.7 million per taxpayer.
- Under current law, the exemption will revert ("sunset") to 2011's original $5 million base amount (adjusted for inflation) on January 1, 2026.
- Under the House's bill, the exemption will revert 2011's $5 million base amount (adjusted for inflation) on January 1, 2022, estimated to be $6.02 million.
- An individual who have not already used their full $11.7 million estate/gift tax exclusion or GST tax exemption should consider doing so before year end if they can afford to do so. If the bill becomes law, the excess exclusion will be lost. It is a use-it or lose-it situation.
- The tax rate remains unchanged at 40%.
- Applies for tax years beginning after December 31, 2021.

Grantor trusts

- **What is a grantor trust?**
  - When a trust qualifies as a grantor trust for income tax purposes, the grantor (or the beneficiary under certain circumstances) is treated for federal income tax purposes as the owner of the trust's assets.
  - Grantor trust status is generally determined based on whether the grantor has retained certain powers under the trust agreement.
  - The benefit of this treatment is that the trust assets can grow without paying income tax out of the trust's assets, and the grantor can essentially make an additional transfer to the trust by paying the tax.
  - In addition, because the grantor and trust are treated as one for income tax purposes, the grantor can sell assets to the trust with no federal income tax consequences.

Grantor trusts

- **Proposed changes**
  - The assets of an irrevocable grantor trust will generally be included in the estate of the grantor upon the grantor's death.
  - If grantor trust status is terminated prior to the death of the grantor or a distribution is made from the trust, the value of the trust or the amount of the distribution will generally be treated as a gift.
  - For purposes of any transfer or sale between a grantor and a grantor trust, grantor status will be disregarded, which means that sales between a grantor and a grantor trust would to be taxed. The proposed legislation would require gain to be recognized on the sale and would deny the recognition of a loss.
  - The changes to the grantor trust rules will apply to trusts created on or after the date of the enactment of the bill and will apply to any contribution to an existing trust on or after that date.
  - There is an exception for trusts that are includable in the grantor's estate under the current rules.

Grantor trusts

- **If enacted, what type of estate planning techniques does this potentially affect?**
  - **Grantor retained annuity trusts (GRATs)**
    - GRATs essentially freeze the value of one's estate by shifting the appreciation of assets out of the estate with little or no gift tax cost. These are known as "zeroed-out GRATs" because the grantor receives annuity payments equal to the amount they fund into the GRAT plus what's known as the 7520 rate.
    - Under current law, the appreciation of the GRAT assets in excess of the 7520 rate, if any, is distributed free of gift tax to the remainder beneficiaries (usually to children or a trust for the benefit of children) at the end of the GRAT term. This assumes the grantor survived the term of the GRAT. GRAT terms are two or more years.
    - Under the House bill, it appears that the final distribution from the GRAT might not pass free of gift tax. Rather, at the end of the GRAT term, the distribution might be treated as if the grantor made a gift equal to the value of the transferred property.

Grantor trusts

- **If enacted, what type of estate planning techniques does this potentially affect?**
  - **Irrevocable life insurance trusts (ILITs)**

    A trust that owns an insurance policy on the life of the settlor or the settlor's spouse or both is a grantor trust. Although such a trust that was created before the bill becomes law would generally continue to be subject to the current rules, any additional contributions—to pay premiums or otherwise—would be subject to the new rules, causing at least some of the death benefits to be includible in the settlor's estate for estate tax purposes.
  - **Spousal lifetime access trusts (SLATs)**

    SLATs are irrevocable trusts created for the benefit of the grantor's spouse and typically other individuals, like the grantor's descendants. When a grantor's spouse is a beneficiary of the trust, it is generally considered a grantor trust. Therefore, if the changes to the grantor trust rules are included in the final legislation, such trusts would have to be structured as a nongrantor trust, but that raises its own complexities and issues. (An adverse party would need to consent to distributions to the settlor's spouse, so we're probably looking at a beneficiary committee.)

Valuation discounts

- The House bill also targets the valuation of certain non-business assets for estate and gift tax purposes.
- A common estate planning strategy currently used is to transfer stock or other property to a family limited partnership (FLP), then make gifts of the FLP units at a reduced value claiming that the interest is subject to a valuation discount because of the lack of marketability or lack of control over the assets.
- The House bill provides that no valuation discount, including for lack of marketability or lack of control, is permitted for non-business assets.
- Non-business assets are passive assets that are held for the production of income (e.g., marketable securities) and not used in the active conduct of a trade or business. There are exceptions for assets used as the working capital of a business or in hedging transactions and for real property used in certain businesses.
- These provisions are effective for tax years beginning after December 31, 2021.

Retirement accounts

- **Contribution limits**
  - Under current law, a taxpayer may contribute to an individual retirement account (IRA) regardless of how much the taxpayer's IRAs hold.
  - Under the House bill, a taxpayer may not make further contributions to an IRA if the aggregate value of certain retirement accounts exceeds $10 million at the end of the prior tax year.
  - The limit applies to
    - single taxpayers (or taxpayers married filing separately) with taxable income greater than $400,000
    - married taxpayers filing jointly with taxable income greater than $450,000
    - heads of households with taxable income greater than $425,000.
  - The provision would be effective for tax years after December 31, 2021.

Retirement accounts

- **Required distributions**
  - The House bill targets large retirement accounts by creating new required minimum distributions for taxpayers who exceed certain income thresholds, regardless of the taxpayer's age.
  - The limit applies to
    - single taxpayers (or taxpayers married filing separately) with taxable income greater than $400,000
    - married taxpayers filing jointly with taxable income greater than $450,000
    - heads of households with taxable income greater than $425,000.
  - If a taxpayer's retirement accounts exceed $10 million in the aggregate at the end of the preceding taxable year, an amount generally equal to 50% of the excess must be distributed to the taxpayer.
  - If the accounts exceed $20 million
    - The excess must be distributed from a Roth account up to the lesser of
      - The amount of such excess, or
      - The balance of the Roth accounts
    - And then any account may be used for the 50% distribution.
  - The distributions are not eligible for rollovers to another retirement account.
  - The provision would be effective for tax years after December 31, 2021.

Retirement accounts

- **Closing the backdoor Roth conversion**
  - Unlike traditional IRAs, Roth IRAs have contribution income limitations. If a taxpayer's income exceeds the limit, the taxpayer may not make a direct contribution to a Roth. However, under current law, conversions from a traditional IRA to a Roth IRA do not have income limitations, which permitted so-called "backdoor" conversions.
  - The House bill eliminates Roth conversions for taxpayers who exceed the income thresholds.
  - This new rule would apply to conversions after December 31, 2031.
    - No, that's not a typo.
    - That's what's in the House draft bill.
    - Based on what our colleagues in the UBS Office of Public Policy have heard, the draft bill is correct, and House lawmakers do, in fact, intend to make that provision effective to conversions after December 31, 2031.
  - This bill also prohibits all employee after-tax contributions in qualified plans and prohibits after-tax IRA contributions from being converted to Roth IRAs regardless of income level.
  - This prohibition is effective for distributions, transfers, and contributions made after December 31, 2021.

Retirement accounts

- **Owner status investments**
  - Under federal tax law, IRAs receive special treatment that defers tax until distributions are made.
  - The House bill threatens that treatment if an IRA holds any security that requires the IRA owner to represent that the individual has a certain amount of assets or income, reached a certain level of education, or attained a certain license or credential.
  - Subject to a two-year transition period for IRAs that hold such securities on the date the measure is enacted, the provision would be effective for tax years beginning after December 31, 2021.

- **Substantial interest investments**
  - Similarly, an IRA may lose its exempt status under federal tax law if it invests in a privately held corporation, partnership, trust, or estate in which the account owner owns at least 10% of such entity or serves as an officer of such entity.
  - This provision is effective for tax years after December 31, 2021.

Qualified small business stock

- Under Section 1202 of the Internal Revenue Code, a portion (or all) of the capital gain from the sale of certain qualified small business (QSB) stock may be excluded from federal tax.
- The House bill reduces the 75% and 100% exclusion rates to 50% for
  - Individuals whose adjusted gross income (excluding gain from QSB stock) is $400,000 or more
  - Trusts
  - Estates
- For the individuals, trusts, and estates subject to this reduced exclusion, there are two additional effects:
  - For the 50% of the gain that isn't excluded, the capital gains rate is 28% (which doesn't include the net investment income tax). The regular long-term capital gains rate applies to gain that exceeds the greater of $10 million and 10 times the taxpayer's basis in the QSB stock.
  - Of the 50% of gain that is excluded, 7% is a tax preference item for purposes of the alternative minimum tax (AMT). Thus, if an individual has $400,000 of adjusted gross income and has $1 million of gain from QSB stock, $35,000 of the gain is added to income for AMT purposes.
- These new rules generally apply to sales and exchanges on or after September 13, 2021. These new rules don't apply to a sale or exchange pursuant to a written binding contract that was in effect on September 12, 2021, and isn't materially modified after that date.

Qualified business income deduction limit

- The TCJA created Section 199A of the Internal Revenue Code, which permits owners of sole proprietorships, S corporations, partnerships, and some trusts and estate to deduct up to 20% of income from a qualified trade or business.
- Under the House bill, Section 199A is amended to cap the maximum deduction at $500,000 for 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.
- The measure applies to taxable years beginning after December 31, 2021.

Corporate tax rates

- The House bill replaces the flat corporate income tax rate with a graduated rate structure as follows:

Income	Rate
$0 to $400,000	18% (reduction from current rate)
Over $400,000 to $5 million	21% (same as current rate)
Over $5 million	26.5% (increase from current top rate)

- A corporation with income greater than $10 million will have additional tax equal to the lesser of (i) 3% of such excess and (ii) $287,000.
- Qualified personal service corporations (as defined for federal income tax purposes) are not eligible for graduated rates and will be taxed at the highest 26.5% rate.
- The new rates would apply to income earned after December 31, 2021.

Wash-sale rule

- The IRS has long prohibited owners of stock and other securities from selling the stock at a loss, repurchasing the stock within 30 days and claiming the loss.
- To close a potential loophole, the House bill includes commodities, currencies, and digital assets in the wash sale rules.
- The provision applies to sales and other dispositions beginning after December 31, 2021.

Curb on conservation easement deductions

- In Notice 2017-10, the IRS made certain pre-packaged conservation easements listed transactions, which requires notice to the IRS of any such transaction.
- The House bill in trying to curb these transactions, would deny a charitable deduction for contributions by partnerships (and other pass-through entities) if the deduction would exceed 2.5 times the sum of each partner's adjusted basis in the partnership that is allocable to the donated property. However, a deduction will be permitted if (i) three-year holding periods are met for the property and partners and (ii) the contribution is from a partnership held by family members.
- Generally, the provisions apply to contributions made after December 23, 2016, based on IRS Notice 2017-10.

Carried interest

- The House bill weakens the preferential tax treatment for carried interest at the favorable long-term capital gains rate but does not eliminate it.
- The bill increases the period that an asset must be held for favorable capital gains treatment from three years under current law to five years.

Estate planning considerations

- **Consider making gifts now.**
  - An individual who has any remaining estate and gift tax exclusion should consider using the remaining exclusion prior to year end. Under the proposed legislation, the Federal estate and gift tax exclusion and GST tax exemption taxes will basically be cut in half after December 31, 2021.
  - An individual who has been contemplating the creation of a SLAT, GRAT, or any other type of irrevocable grantor trust, time is of the essence in having that trust drafted and funded. As mentioned earlier, under the House bill, the changes affecting grantor trusts would be effective upon enactment of the bill.

Estate planning considerations

- **Existing ILITs or other irrevocable grantor trusts**
  - An individual who has an ILIT in existence and makes annual gifts in order to fund premiums should consider whether to make a larger gift to cover expected premiums for the duration of their life (assuming they have exclusion remaining). At a minimum, they may want to fund the trust with the next premium in the next few weeks (again, assuming they can make an annual exclusion gift or use remaining exclusion).
  - An individual who has an existing irrevocable grantor trust that holds low-cost basis property might consider whether they should swap those assets for cash or higher basis assets before enactment of the bill.
  - An individual who has an irrevocable grantor trust that may experience a sizable income tax recognition event should explore their options. They may want to change the status of the trust to a nongrantor trust (turn off grantor trust status) so that the trust pays the income tax. Again, remember, as the bill is currently drafted, that would need to be done prior to enactment to avoid the grantor being treated as making a gift of assets held by the trust (with an offset for prior gift tax reported). They may also want to consider a tax reimbursement payment from the trust, a distribution if it's a SLAT or a self-settled spendthrift trust, or even possibly a loan (depending on how the new rules are interpreted), all of which may still be viable options.

Income tax planning considerations

- Chances are high that income tax rates for individuals and corporations are going up. To the extent an individual can accelerate the income into this year rather than next, they are likely to be taxed at a lower rate. This does not apply to capital gains, as the proposed legislation makes the capital gain rate change effective as of the date the bill was introduced (i.e., September 13, 2021).
- An individual might consider delaying charitable gifts until next year when the deduction will be more impactful to their personal income taxes because of the higher rate.

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