

September 14, 2021

### Tax Reform Update – House Ways and Means Committee Proposal

On September 13, 2021, the US House of Representatives Ways and Means Committee released its anticipated proposed tax changes to finance a budget reconciliation spending bill later this year. This is the first legislative step in enacting the tax reform that President Biden and Congressional Democrats have spoken about throughout the year. It should be noted that these are merely proposals, and negotiations are ongoing surrounding the exact provisions which will be in the legislation.

The proposals outlined by the Ways and Means Committee aim to fund spending increases through individual and corporate tax reform. While corporate tax reform is outside of the scope of this article, some of the key individual income tax proposals include the following:<sup>1</sup>

- Increase Top Capital Gains Rate to 25%: The top long-term capital gains rate would be increased from 20% to 25% **effective September 13, 2021** (the “Date of Proposal”). This rate is lower than the 39.6% rate that President Biden has proposed. While President Biden proposed applying the top rate to taxpayers with Adjusted Gross Income above \$1 million, the Ways and Means Committee proposal appears to apply the 25% rate to those in the top income tax bracket.
- Increase Top Income Tax Rate to 39.6%: This provision would increase the top tax bracket from 37% to 39.6% on incomes over \$450,000 (\$400,000 for individuals filing Single). This provision would take effect on January 1, 2022.
- Impose a 3% Surtax on Modified Adjusted Gross Income Over \$5 Million: In addition to the increased top Federal rate, a 3% surtax would be imposed on all income over \$5 million. This is a new proposal which was not initially included in President Biden’s proposals earlier this year. This provision would take effect on January 1, 2022.
- Section 199A Phaseouts: Individuals with income over \$400,000 (married couples with income over \$500,000) would no longer be eligible for a Section 199A deduction for Qualified Business Income (“QBI”).
- Small Business Stock Sale Limitations: The proposal would limit the 75% and 100% exclusion rates for gains realized on certain small business stock to those with AGI below \$400,000.
- Carried Interest Limitations: The proposal would require investment managers to hold assets for more than five years (up from three years) to receive preferential capital gains treatment. The carried interest provisions are a valuable tax break for private equity managers that have come under Legislative attack in recent years, with President Biden proposing to eliminate the preferential rate for those making over \$400,000.

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<sup>1</sup> A summary of the entire House Ways and Means Committee proposal can be found at <https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/SubtitleISxS.pdf> (last accessed September 14, 2021).

- Reduction of Estate and Gift Tax Unified Credit to \$5 Million (Plus Inflation): The Federal estate and gift tax exemption implemented under the Trump Tax Cuts and scheduled to expire after December 31, 2025 would be terminated effective January 1, 2022. In effect, the estate and gift tax exemption would be reduced from \$11,700,000 in 2021 to \$5,000,000 (indexed for inflation back to 2010) in 2022.
- Limits on Discount Valuations: The proposal would eliminate the discount for lack of marketability and lack of control for transfer tax purposes for passive assets.
- Changes In Rules for Grantor Trusts: Effective on the date of enactment (the date the bill is passed), any Grantor trusts or contributions to Grantor trusts would be includable in the estate of the grantor. This provision would also treat sales between the grantor and Grantor trusts as sales between the grantor and third parties. This would effectively eliminate the “Sale to Intentionally Defective Grantor Trust” strategy. With respect to this provision, there may be a very brief window during which to complete any transfers to Grantor trusts and have those transfers not be included in the estate of the grantor.
- Eliminate Backdoor Roth Conversions and Limit the Use of Roth Conversions for High Income Taxpayers: Individuals who earn over \$400,000 (\$450,000 for married couples) would be ineligible to convert their IRA or employee plan to Roth IRA effective January 1, 2022. Additionally, the proposal prohibits all employee after-tax contributions in qualified plans and prohibits after-tax IRA contributions from being converted to Roth, regardless of income level, thereby eliminating the “backdoor Roth conversion.”
- Prohibit IRA Contributions and Create RMD for High-Income Individuals with Large Retirement Account Balances: Individuals who earn over \$400,000 (\$450,000 for married couples) would be subject to special rules if their total account balance of all IRA, Roth IRA, and defined contribution accounts exceeds \$10 million. In these situations, the taxpayer would be unable to make additional contributions to the IRA and would be required to take a Required Minimum Distribution equal to 50% of the value by which the accounts exceed \$10 million.
- Prohibit IRA From Holding Assets Conditioned on Account Holder’s Status: This provision would prohibit an IRA from holding any security in which the issuer requires the IRA owner to have a minimum level of income or assets or completed a minimum level of education. For example, an IRA would not be allowed to hold investments offered only to accredited investors. There would be a 2-year transition for investors who already own disqualifying assets in their IRA.
- Additional IRS Funding: The proposal would allocate approximately \$80 billion to the IRS to increase tax enforcement activities with the direction that no funds are intended to increase taxes on any taxpayer with taxable income below \$400,000.

Notably absent from the Ways and Means Committee proposal is the following:

- No Mention of Changes to SALT Deduction: The proposal does not include any changes to the State and Local Tax (“SALT”) deduction. Under the Trump Tax Cuts, taxpayers are limited to a \$10,000 itemized deduction for state and local taxes paid. Many Congressional Democrats have advocated increasing or eliminating this cap, and since the release of the proposal, there have been several calls to include SALT deduction reform in the budget reconciliation bill.

- **No Mention of Capital Gains at Death:** A commonly discussed provision of President Biden’s tax plan was to eliminate the “step up in basis at death” by taxing unrealized capital gains at death. The House Ways and Means Committee proposal does not include any reference to changes to the basis rules upon passing.

The next step in the process is for the House Committee to discuss the proposals in a hearing and mark up the bill. As discussed earlier, negotiations are ongoing, and any of the provisions and effective dates listed above are subject to change in the final bill. In order for the bill to be passed through the budget reconciliation process, a majority of the House and Senate would need to vote in favor of the bill. Practically speaking, this means that in order to pass a bill in the Senate without Republican support, all 50 Democratic Senators would have to vote in favor of the bill, which would then allow Vice President Harris to cast the deciding vote. Given that any tax reform bill will require near unanimous support of House Democrats, and the support of all 50 Democrat Senators, changes to this bill are likely before it appears in final form.<sup>2</sup>

***This analysis was prepared by members of the financial planning design team at Summit Financial LLC (“Summit”). The Summit financial planning design team includes attorneys and/or CPAs who act exclusively in a non-representative capacity with respect to Summit’s clients. Neither they nor Summit provide tax or legal advice to clients. Clients should make all decisions regarding the tax and legal implications of their investments and plans after consultation with their independent tax or legal advisors. Any tax statements contained herein were not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal, state, or local taxes.***

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<sup>2</sup> For example, Senator Menendez of New Jersey indicated that it would be “hard to support” a final tax plan that does not include a reform to the cap on the SALT deduction. House Ways and Means Committee Chairman Richard Neal also released a joint statement with House Democrat Representatives Suozzi and Pascrell committing to “meaningful SALT relief,” although the initial bill is silent on changes to the SALT deduction. Representative Suozzi has repeatedly indicated that he would be reluctant to support any bill that does not include reforms to the SALT deduction cap.