House Democrats Weigh Major Tax Changes for Businesses, Funds, and Individuals

October 12, 2021 | Alert | By **Anthony M. DeMaio**

By **Gregg M. Benson**, **Anthony M. DeMaio**

In May 2021, President Biden's administration released a $6 trillion budget proposal for the coming fiscal year (Budget), including $3.6 trillion of tax increases over 10 years and generous tax credits to incentivize clean energy and certain infrastructure projects. The tax-related aspects of the Budget are explained in the U.S. Treasury Department's General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (Green Book).

While the Green Book served as a blueprint for the Biden administration's tax priorities, on September 13, 2021, the U.S. House Ways and Means Committee provided a more concrete package of proposed tax legislation (House Bill) that the Democrats plan to enact using budget reconciliation, which requires a simple majority vote in the Senate. Republicans used the same reconciliation process to pass the Tax Cuts and Jobs Act of 2017 (TCJA). The tax provisions in the House Bill are intended to fund, in part, the price tag of the "Build Back Better" plan. This is the ambitious $3.5 trillion proposal to enact Democratic priorities like expanding Medicare, providing universal child care and paid family leave, and extending the child tax credit, among a litany of other provisions. Tax professionals and commentators have noted that the tax provisions of the House Bill are more moderate than those contained in the Green Book.

Some of the key provisions of the House Bill are set forth below:

Tax Rate Changes

- Tax rates would increase, moving the maximum income tax rate for corporations to 26.5% from 21%, and for individuals, trusts, and estates to 39.6% from 37%.
- The long-term capital gains rate for individuals with taxable income above a threshold amount of $400,000 ($450,000 for joint filers) would increase to 25% from 20% for transactions effected on or after September 13, 2021, subject to a transition relief rule that retains the 20% rate for transactions effected on or after this date pursuant to a binding written contract entered into prior to such date. This increase in the long-term capital gains rate would also cause the tax rate on qualified dividend income to be taxed at 25%.
- For tax years beginning after 2021, the House Bill would subject all trade or business income (including income earned through S corporations) of individuals earning over $400,000 ($500,000 in the case of joint filers) to the 3.8% net investment income tax, unless that income is subject to self-employment tax.
- Certain high-income non-corporate taxpayers with modified adjusted gross income in excess of $5 million would be subject to a new 3% tax on such excess.

Changes to the Estate and Gift Tax Regime

- The TCJA increased the lifetime U.S. gift and estate tax exemption from $5 million to $10 million (in each case, adjusted annually for inflation since 2010) for periods beginning in 2018 and ending prior to 2026. This provision is scheduled to expire for transfers after 2025, following which, in the absence of legislation, the U.S. gift and estate tax exemption reverts to pre-TCJA levels. For transfers in 2021, the exemption amount is $11.7 million. The House Bill proposes to accelerate the return to pre-TCJA levels for transfers after 2021, essentially cutting the exemption (including the generation-skipping tax exemption) in half to approximately $5.85 million.
- The House Bill proposes significant changes to the existing grantor trust rules that are intended to cause the treatment of a grantor trust for estate tax purposes to more closely align with the treatment of a grantor trust for income tax purposes. Under current law, a grantor that transfers assets to a grantor trust is treated as directly owning the assets held by such grantor trust for U.S. income tax purposes, and as a result, transactions between the grantor and the grantor trust are typically disregarded for U.S. income tax purposes. However, certain grantor trusts (such as an intentionally defective grantor trust) may be structured in such a way as to allow for assets held by the grantor trust to be excluded from the grantor's estate for estate tax purposes. The House Bill would upend these rules by (i) causing in many cases assets held by a grantor trust that otherwise provides estate tax protection to be pulled back into

the grantor's estate for estate tax purposes and (ii) treating transfers between a grantor trust and a deemed owner of the underlying grantor trust assets as taxable exchanges. Under the House Bill, existing grantor trusts will be grandfathered and not subject to this proposal, which is intended to apply to grantor trusts formed on or after the House Bill's enactment.

Changes to the International Tax Regimes

- The House Bill proposes substantial changes to the "global intangible low-tax income" (GILTI) regime applicable to certain U.S. shareholders of "controlled foreign corporations" (CFCs) introduced by the TCJA, including (i) reducing the "qualified business asset income" (QBAI) exemption from a deemed 10% return on depreciable tangible assets to 5%, (ii) increasing the effective rate of tax on GILTI for U.S. corporate shareholders from 10.5% to 16.5625% and (iii) applying the GILTI regime on a country-by-country basis. In addition, the House Bill proposes to allow carryforwards of GILTI losses and increase the foreign tax credit with respect to GILTI income from 80% to 95%.
- The House Bill would reduce the deduction available to U.S. corporations against certain income derived from export activities permitted under the "foreign derived intangible income" (FDII) rules of the TCJA from 37.5% to 20.7% for tax years beginning after 2021.
- Under the TCJA's "base erosion and anti-abuse tax" (BEAT), corporations with average gross receipts exceeding $500 million are subject to a minimum tax generally equal to the 10% (the current BEAT rate) of their "modified taxable income," determined by adding back certain otherwise deductible payments made to foreign related parties. The House Bill proposes to increase the BEAT rate from 10% to 12.5% beginning in 2024 and then to 15% beginning in 2026.
- The House Bill proposes to narrow the availability of the "portfolio interest exemption," which eliminates U.S. withholding tax on certain interest paid by U.S. borrowers to non-U.S. lenders by expanding the existing 10% shareholder exclusion from the portfolio interest exemption. The current 10% shareholder exclusion provides that the portfolio interest exemption is not available where the non-U.S. lender owns stock representing at least 10% of the *voting power* of the U.S. borrower. The House Bill would expand this by also excluding from the portfolio interest exemption interest paid to a non-U.S. lender that owns stock representing at least 10% of the *value* of the U.S. borrower.
- One taxpayer friendly provision included in the House Bill would be to reinstate (except for certain limited circumstances) the pre-TCJA rule that prohibited "downward attribution" from a non-U.S. person to a U.S. entity for purposes of determining whether the U.S. entity is a "United States shareholder" of a CFC subject to reporting requirements and current inclusion of "subpart F income" and GILTI. The repeal of the downward attribution prohibition included in the TCJA was considered by many taxpayers and tax commentators to be overly broad and created CFC reporting and current income inclusion obligations in unintended situations. This would be a welcome relief to many taxpayers.
- Although not directly related to the international tax provisions described above in the House Bill, recent tax developments in the international community could further impact the direction of U.S. tax legislation. The Organization for Economic Cooperation Development (OECD) recently announced that 136 counties have agreed to a long-negotiated deal pursuant to which such countries will impose a global minimum corporate tax rate of 15%. The imposition of the global minimum tax could result in some international income that would otherwise be subject to U.S. tax (including, under the subpart F income and GILTI rules described above) being subject to local country tax instead. However, the Biden administration and U.S. Treasury Secretary Janet Yellen ultimately believe that this agreement is a good step towards the goal of ending the so-called global "race to the bottom" pursuant to which countries compete to attract companies with ever-lowering tax rates.

Other Changes Impacting Businesses, Funds, and Individuals

- The taxation of "carried interests" was modified by the TCJA, which imposed a three-year holding period in order for the holder of the carried interest to get long-term capital gain treatment, with the holding period being determined at the level of the property being sold (whether it's the holder selling the carried interest or the partnership selling an underlying investment). Although the House Bill does not go so far as to eliminate carried interest treatment, it does extend the long-term capital gain holding period requirement from three years to five years.
- The House Bill proposes to reduce the benefit available to certain non-corporate taxpayers holding "qualified small business stock" for more than five years. Under current rules, taxpayers may be able to exclude up to 100% of the gain on a sale of such stock. The House Bill would only permit a 50% exclusion on the sale of such stock, applicable to sales occurring on or after September 13, 2021 (or sales that take place prior to January 1, 2022 pursuant to a binding contract entered into on or before September 13, 2021).
- The deduction (up to 20%) available to non-corporate taxpayers under the TCJA on their U.S. trade or business income earned through a pass-through entity (e.g., a sole proprietorship, partnership, S corporation) would be limited to $400,000 ($500,000 for joint filers and $250,000 for married individuals filing separately) for tax years beginning after 2021.
- The House Bill would also permit any S corporation in existence on May 13, 1996 to convert to, or reorganize as, a partnership on a tax-free basis if the conversion or reorganization is completed by December 31, 2023.

Omissions

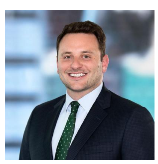
Some items previously discussed by President Biden either during his campaign or in the Green Book were not included in the House Bill, including:

- A repeal of the $10,000 cap on the deduction for state and local taxes (SALT), which several Congressional Democrats had previously stated would be necessary for them to support any tax legislation proposed by the Biden administration.
- A proposal that was included in the Green Book (and received much attention) to eliminate the current rule that permits a fair market value tax basis step up to assets held by a decedent on the decedent's death. Specifically, the Green Book proposed that a donor or decedent be required to recognize any unrealized appreciation in certain assets transferred by gift or upon death after December 31, 2021.
- A proposed expansion of the U.S. anti-inversion rules that would have broader application, making it more difficult to engage in transactions that could otherwise remove U.S. businesses, entities, and income from the U.S. tax base directly or indirectly transferring a U.S. business under a new foreign parent corporation.

Conclusion

Although the House Bill is just the next step in what is certain to be a highly negotiated political process, it seems to be trying to strike a balance between supporting the ambitious and expansive agenda and programs of the Biden administration and concerns of some House members of imposing too large of a tax increase on businesses and individuals (compared to the proposals contained in the Green Book). As of the date hereof, compromise proposals are being considered that would significantly decrease the scope and cost of some of Biden's programs, which would also decrease the amount of revenue that needs to be raised through tax increases. In addition, some Democrats, especially in higher-taxed states, are looking to deliver on promises to eliminate the cap on SALT deductions. As a result, we expect to see negotiations and changes to the legislation contained in the House Bill before its ready to be voted on and signed by President Biden. That being said, Biden and Congressional Democrats are certainly looking to deliver a victory on some of the campaign promises that resulted in Democrats taking control of the White House and both Houses of Congress. However, much uncertainty remains over the extent to which Democrats will be able or willing to push through their Build Back Better agenda and supporting tax legislation in the face of Republican (and some intraparty) opposition.

Authors



Anthony M. DeMaio, Senior Vice President

Anthony M. DeMaio, Senior Vice President of Government Relations of ML Strategies, draws on over a decade of experience in government affairs and communications - working with members of the Massachusetts congressional delegation - to lobby on behalf of a variety of clients and assist them with congressional investigations and media messaging.