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House Proposal 5376

Greetings!

In an earlier update, we discussed tax law changes that were proposed primarily by Senators Bernie Sanders (“For the 99.5 %”), Chris Van Hollen (“Sensible Taxation and Equity Promotion (STEP) Act”) and President Biden. House Proposal 5376, to be incorporated in the House budget reconciliation bill, includes much but not all of what is contained in those earlier proposals.

The following highlights those provisions we think would be of most interest to you.

Individual Income Taxes

Tax Rates: The top marginal individual income tax rate would increase from 37% to 39.6%. This marginal rate would apply to married individuals filing jointly with taxable income over $450,000, to heads of household with taxable income over $425,000, to unmarried individuals with taxable income over $400,000, to married individuals filing separate returns with taxable income over $225,000, and to estates and trusts with taxable income over $12,500. This change applies to tax years beginning after December 31, 2021.

3.8% Net Investment Income Tax: Under current law, the 3.8% tax generally only applies to passive investment income (interest, dividends, gain on the sale of stock, etc.).

Under the House Proposal, effective for tax years after 2021, the Net Investment Income Tax (NIIT) would be broadened to include any income derived in the ordinary course of business for single filers with more than $400,000 in taxable income ($500,000 for joint filers). The tax will apply to distributions from S corporations, LLCs, and partnerships. This will eliminate the planning approach used by many of paying distributions from the pass-through entity in lieu of higher salary.

The Net Investment Income Tax will also apply to trust and estate income beginning at $13,050 of net taxable income in 2021, and the threshold will increase slightly each year. The NIIT is not assessed on earnings already subject to FICA tax.

High-Income Surcharge: The Proposal would impose a surcharge tax equal to 3% of a taxpayer's modified adjusted gross income (MAGI) in excess of $5 million (or in excess of $2.5 million for a married individual filing separately). For this purpose, modified adjusted gross income means adjusted gross income reduced by any deduction allowed for investment interest (as defined in Section 163[d]).

Capital Gains: The capital gains tax rate would increase from 20% to 25%, effective for tax years ending after September 13, 2021. However, a transition rule would provide that the current statutory rate of 20% would continue to apply to gains and losses for the portion of the tax year prior to September 13, 2021 and gains recognized after September 13, 2021 that arise from transactions entered into before September 13, 2021 pursuant to a written binding contract (and which is not modified thereafter in any material respect). Most capital gains would also be subject to an additional 3.8% tax.

Digital Assets: The Proposal subjects “any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology”, i.e., cryptocurrency to the “wash sale” and “constructive sale” rules of the Internal Revenue Code.

A wash sale occurs when an individual sells stock or security at a loss, but within 30 days before or after this sale, the individual buys a "substantially identical" stock or security or acquires a contract or option to do so. Section 1091 of the Code prevents the individual from immediately using such a loss by effectively ignoring the sale transaction and adding the amount of loss to the cost of the replacement stock or security; in effect, the loss is deferred until the replacement stock or security is itself sold. Section 1091 currently applies only to stocks or securities; it does not apply to cryptocurrency since the IRS treats cryptocurrency as property and not a stock or a security. If enacted, cryptocurrency transactions occurring after December 31, 2021 would be subject to the wash sale rule.

Constructive Sales: Section 1259 of the Code generally requires taxpayers to recognize gains with respect to an appreciated financial position as if the position was sold for its fair market value on the date of the constructive sale. An appreciated financial position generally means any position with respect to stock, debt instruments, or partnership interests with built-in gain. A taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) (1) enters into a short sale of the same or substantially identical property, (2) enters into an offsetting notional principal contract with respect to the same or substantially identical property, (3) enters into a futures or forward contract to deliver the same or substantially identical property, or (4) acquires the same or substantially identical property in the case of an appreciated financial position that is a short sale or a contract described in (2) or (3). The rules are generally intended to prevent taxpayers from monetizing investment gains without realizing taxable gains.
The Proposal would expand the definition of an "appreciated financial position" to include positions in "digital assets", as defined in the proposed amendment to Section 1091. In addition, the Proposal would provide that a constructive sale occurs when a taxpayer acquires "or enters into a contract to acquire" the same or substantially identical property when the appreciated financial position is a short sale or contract described in IRC Section 1259(c)(1)(B) or (C). The modified rules generally would apply to constructive sales entered into after the

date the legislation is enacted.

Estate and Gift Tax Provisions

Exemption: The Gift, Estate, and Generation Skipping Transfer Tax Exemptions. Effective for decedents dying and gifts made after December 31, 2021, the House Proposal would reduce the current $11.7 million estate, gift and GST exemption from $5,000,000, adjusted for inflation, which would be $6,030,000 in 2022.

Grantor Trusts

Current Law: Grantor trusts allow the grantor to make a gift to a trust that, with proper planning, will be excluded from the grantor's estate and also allows the grantor to pay income tax on all trust income without such payments being considered a gift to the trust or its beneficiaries. Further, many Grantor trusts contain a provision allowing the grantor to substitute the grantor's high income tax basis assets for low or even negative basis assets of equivalent value that are owned by the grantor trust. By so doing, the grantor's beneficiaries benefit from a FMV basis in the assets held in the Trust and the low basis assets formerly held by the Trust and owned by the grantor at death will receive a basis equal to the fair market value as of the grantor's date of death.

Pre-Enactment Trusts (Grandfathered Trusts): Trusts created before enactment should maintain full grantor trust benefits so long as the trust is not modified after enactment and there are no contributions to such trust. Grantor trust status will be eliminated, at least to some degree, based upon the value of post enactment contributions in the event contributions are made to the trust after enactment. At this point it is unclear whether a grandfathered trust will lose its grantor trust status if assets are substituted by the grantor or sold by the grantor to the trust subsequent to enactment. It is also unclear whether modification of an existing grantor trust will result in loss of grantor trust status.

Post Enactment Trusts: The House Proposal eliminates the ability to take advantage of grantor trust planning for any trust created or funded after enactment. The Proposal, which creates Section 2901 of the Code:

- Includes in a grantor's taxable estate any portion of the grantor trust's assets of which the person is the "deemed owner" for income tax purposes.
- Treats a distribution made from a grantor trust as a gift, unless (a) the distribution is made to the grantor's spouse or (b) the distribution discharges an obligation of the deemed owner.
- Provides that if the trust's grantor trust status is terminated during the grantor's lifetime, the assets will be treated as being gifted at that time by the grantor. A "proper adjustment" will be made if assets of a grantor trust are included in the grantor's taxable estate to account for amounts previously treated as taxable gifts by the grantor to the trust.

Income Taxation

Sales to Grantor Trusts

Current Law: Under current law, when a grantor sells appreciated assets to a grantor trust, no capital gain is triggered. In addition, under existing law, the "swap" or "substitution" of assets of equal value for assets in a grantor trust does not trigger capital gain.

Proposed Law: Effective with regard to trusts created on or after the date of enactment (or to a portion of a trust that was created before the date of enactment which is attributable to a contribution made on or after the date of enactment), the House Proposal would add new Section 1062 to the Code, which would require gain to be recognized on sales of appreciated assets to a grantor trust, but not allow recognition of a loss. Further, "swap" or "substitution" transactions would no longer be free of capital gains tax consequences as to post enactment created grantor trusts. Moreover, it appears that if a grantor trust transfers an asset that it owns that is worth more than the tax basis of the asset, then income tax may be triggered as if the asset was sold to a third party.

The grantor trust provisions of the House Proposal will eliminate the benefits of techniques such as Grantor Retained Annuity Trusts("GRATS"), Spousal Limited Access Trust ("SLATS"), Qualified Personal Residence Trusts ("QPRTS") and Charitable Lead Annuity Trusts ("CLATS") as well as most life insurance trusts created or funded after enactment, and to a more limited extent, even pre-enactment life insurance trusts funded after enactment.

Family Limited Partnership and Other Valuation Discount Limits as Non-Business Assets

Under the House Proposal, effective for transfers after the date of enactment, nonbusiness assets held by an entity are valued with no valuation discount and the nonbusiness assets would not be taken into account when valuing the entity. The new rules apply to the transfer of nonbusiness assets that are held by an entity that is transferred after the date this proposal is enacted. The Proposal defines "non-business assets" as passive-type assets (i.e., a portfolio of stocks, bonds, mutual funds, any like type assets), which is held for the production or collection of income and is not used in the active conduct of a trade or business.

The House Proposal effectively eliminates discounts for entities other than assets used in an active business. Importantly, the rule only applies to entity interests. Therefore, if an interest in a piece of real property is transferred, discounts could still be applied.

IRA and Retirement Plans

Contributions to IRAs: The House Proposal would prohibit further contributions to a Roth or traditional IRA for a tax year if the total value of an individual's IRA and defined contribution retirement accounts exceeds $10 million as of the end of the prior tax year. The limit on contributions would only apply to single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation) (hereinafter "high-income taxpayers").

Required Minimum Distributions: For high-income taxpayers whose

combined traditional IRA, Roth IRA, and defined contribution retirement account balances generally exceed $10 million at the end of a tax year, a minimum distribution would be required for the following year as follows:

- If the individual's prior-year aggregate traditional IRA, Roth IRA, and defined contribution account balance exceeds the $10 million limit, but is less than $20 million, 50% of the value in excess above $10 million must be distributed as taxable income.
- If the individual's prior-year aggregate traditional IRA, Roth IRA, and defined contribution account balance exceeds $20 million, 100% of the value in excess above $20 million must be distributed as taxable income.

IRA Investments: IRAs can no longer invest in entities in which the IRA owner has a 10% or greater ownership interest (this is presently 50%), or if the IRA owner is an officer. This will also be considered an IRA requirement rather than a prohibited transaction, which means that if the IRA invests even a small part of its holdings in such a business the entire IRA will be disqualified, resulting in loss of creditor protection status and having taxes apply as if the IRA was liquidated. There is a proposed two year transition period of IRAs currently invested in these types of investments.

Roth Conversions: The House Proposal would eliminate Roth conversions for both IRAs and employer-sponsored plans for high income taxpayers. This provision would apply to distributions, transfers, and contributions made in taxable years beginning after December 31, 2021. It would also prohibit employee after-tax contributions to qualified plans and IRAs from being converted to Roth regardless of income level, effective for distributions, transfers, and contributions made after December 31, 2021.

Not Part of the House Proposal

- no deemed sale at death
- no elimination of the basis step-up at death to fair market value
- no increase in the current 40% estate, gift, and generation skipping transfer tax rate
- no taxation of appreciated assets that are transferred into or out of separately taxed trusts
- no reduction of the amount of annual gifts exclusion
- no reduction of the lifetime gift tax exemption to $1,000,000
- no generation skipping tax via a deemed termination of a dynasty trusts every 50 years
- no changes to Section 1031 like-kind exchanges

What to Do Before Enactment

There are numerous planning techniques that you may wish to consider initiating now, before the effective date of the new law:

- High income taxpayers may wish to accelerate the realization income to the current year so that income earned this year will be taxed at 37% instead of 42.6%.
- If you are contemplating a Roth conversion, consider doing so before the income tax rate increases are effective.
- Make outright gifts equal to your remaining gift, estate, and generation

skipping transfer tax exclusions.

- If you have an existing grantor trust that has outdated provisions, including dispositive provisions, decant such trusts into a new updated grantor trust, or modify such trusts (if allowed under the trust terms of your trust) to avoid the negative tax consequences that may result from the House Proposal.
- Create a family limited partnership or LLC that holds passive assets before the effective date of the Proposal and gift or sell interests in such entities using discounted values.
- Create GRATS, SLATS, and other grantor trusts (using valuation discounts), and gift discounted partnership or LLC interests using your remaining gift, estate, and generation skipping transfer tax exclusions.
- Substitute assets into a grantor trust for other assets of equivalent value.
- Fund an irrevocable grantor trust that holds insurance with cash so you don't have to make future gifts to the trust to cover the premium costs.
- Review prior gifts in trust for which GST exemption was not allocated. If there is a possibility said gifts may be distributed to grandchildren or later generations and thus potentially subject to GST tax, make an allocation of GST exemption on a Form 709 for the current year based on the current value of the trust assets so that the entire trust is GST exempt. The effective date of the allocation of exemption will be the date the Form 709 is postmarked to the IRS.

If you wish to discuss the Proposal, its potential impact on your current tax plan, and strategies to enter into before the effective date, please contact our office. There may be only limited time to act before enactment.

From the desk of Rona S. Fingold

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