MEMORANDUM

Tax Legislation Update

June 15, 2021

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TO: Clients and Preferred Advisors
FROM: Chad Baker
DATE : June 15, 2021
RE: Tax Legislation Update

Biden Administration Proposes Elimination of Stepped-Up Basis at Death

On April 28, 2021, the Biden administration proposed eliminating stepped-up basis on gains for many taxpayers when stocks, real estate, and other capital assets (such as business ownership and assets) are passed down to heirs. The proposal would modify Internal Revenue Code section 1014, which currently provides that the basis of inherited assets is reset to the present fair market value as of the date of the decedent's death, exempting heirs from paying taxes on unrealized capital gains.

Under the proposal, the step-up in basis would no longer apply to gains over $1 million—or $2.5 million per couple when combined with real estate exemptions that exist under current law. It is unclear whether the proposal would create deemed sales at death. The reform would (i) not apply to transfers to charity, and (ii) would provide protections to family-owned businesses and farms, exempting them from the payment of taxes when given to heirs who plan to continue to run the business or farm, **however, the proposal does not contain any details regarding the nature or extent of these exemptions.**

Congressional Democrats Propose Elimination of Stepped-Up Basis at Death and for Gifts

On March 29, 2021, Senate Democrats proposed a discussion draft for the Sensible Taxation and Equity Promotion (STEP) Act of 2021 and House Democrats introduced H.R. 2286, a corresponding bill that would eliminate the step-up in basis allowed under current tax law and create deemed sales at death or when gifts are made. One major difference in the two congressional proposals is that the STEP Act would apply retroactively to gifts made and

estates of decedents who died after December 31, **2020**, whereas H.R. 2286 would apply to those after December 31, **2021**.

The STEP Act would provide an exclusion from tax of $100,000 for gifts and of up to $1 million for transfers at death (reduced by any exclusion used for gifts) for unrealized capital gains. The capital gains tax applicable to illiquid assets such as farms or businesses could be paid in installments over fifteen years. In addition, the current exclusions of up to $250,000 for individuals and $500,000 for spouses filing jointly for personal residences and assets held in retirement accounts would still apply under the STEP Act. Gifts and bequests made to charitable organizations would be exempt from capital gains tax as well. Income tax paid pursuant to the STEP Act would be deductible for estate tax purposes, partially mitigating the effect of the estate tax (but NOTE, this is a new tax in addition to the estate tax). Nongrantor trusts would be required to pay tax on capital gains every 21 years, with trusts created in 2005 or earlier having their first "deemed realization" in 2026.

Takeaways: In addition to creating additional tax liability at death, the elimination of stepped-up basis at death would make estate administration considerably more complicated because of the need to establish the historical tax basis of assets after the original owner's death—particularly for assets that have been owned for decades or even multiple generations. Some clients should consider purchasing additional life insurance to provide heirs with the liquidity to pay capital gains taxes due upon the clients' death.

If enacted, these changes could significantly impact the results under current Buy-Sell agreements or other business transition plans. It may be a good time to review these agreements to be sure they adequately accomplish the intended outcomes.

Senate Republicans Propose Estate and Generation-Skipping Tax Repeal

Senator John Thune introduced the Death Tax Repeal Act of 2021, which would repeal the estate and generation-skipping transfer tax and modify the

computation of the gift tax. If the bill is passed, the gift tax rate would begin at 18 percent on transfers of less than $10,000 and increase incrementally to 35 percent on transfers over $500,000. In addition, the estate tax would continue to apply to distributions from qualified domestic trusts made after enactment for the surviving spouse of a decedent who dies before the date of enactment.

Takeaways: With Democrats in control of the legislative and executive branches, a repeal of the estate tax is unlikely. Although the Biden administration has indicated an intention to increase the estate tax rates and lower the exemption amount, it has chosen to omit changes to the estate tax from its April 28, 2021, American Families Plan proposal. At present, the current estate tax exemption amount ($11.7 million for individuals for 2021) is due to sunset on December 31, 2025, returning to the previous rate of $5 million for individuals (adjusted for inflation).

Biden Administration Proposes Increase in Corporate Tax Rate

On March 31, 2021, the Biden administration released its Made in America Tax Plan, a tax proposal designed to generate enough revenue to pay for the American Jobs Plan, its $2.3 trillion infrastructure spending proposal. The following are several of the proposed changes under the Biden plan:

- The corporate income tax rate would increase from 21 to 28 percent
- A 15 percent minimum tax would be imposed on the book income of large corporations with high profits but little taxable income
- The global adoption of higher minimum tax rates would be encouraged
- The global minimum tax on foreign profits of multinational corporations headquartered in the United States would increase from 10.5 percent to 21 percent

Takeaways: For smaller businesses, the proposed increase in the federal corporate income tax rate, which would partially undo the 2017 reduction from 35 to 21 percent, would make incorporation less attractive. The other aspects of the Biden proposal are unlikely to have a direct impact on small domestic businesses.

Treasury “Green Book” Outlining Biden’s Proposed Tax Changes for 2022 Fiscal Year Budget

On May 28, 2021, the Treasury Department released the General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals (sometimes called the Green Book) to accompany President Biden’s proposed budget for FY 2022. If enacted, the Green Book proposals would significantly increase tax burdens on corporate and individual taxpayers and make sweeping changes to the international tax regime that was overhauled in 2017 by the Tax Cuts and Jobs Act (TCJA). The proposals also would significantly impact planning for transfers of wealth by treating transfers by gift and at death as realization events for income tax purposes. Also, in line with the Biden administration’s policy goals related to renewable energy, the Green Book sets forth numerous proposals to expand tax benefits favoring clean energy and rescind tax incentives currently available with respect to fossil fuels.

Treasury officials have described the Green Book as a “conceptual” document providing a starting point for discussions with Congress. Prior to the enactment of any new tax legislation, the Treasury Department may build upon the Green Book by modifying or abandoning some of these proposals or offering new ones (including, for example, modifying or repealing Section 199A). Below, we provide a brief description of certain noteworthy proposals in the Green Book (including commentary from Treasury officials) relating to personal and wealth transfer taxes and offer our observations.

Increase Top Individual Rate: The top rate for individual taxpayers would increase from 37% to 39.6%. The number of people subject to this top rate also would increase due to the application of the top rate to income over $452,700 ($509,300 for married taxpayers filing jointly), as compared to $523,601 ($628,301 for married taxpayers filing jointly) in 2021. Notably, the Green Book deviates from President Biden’s campaign proposals by omitting any revival of the Pease limitation or other policies that would reduce the value of itemized deductions.

Tax Capital Gains as Ordinary Income: Currently taxed at preferential rates, long-term capital gains and qualified dividend income would be taxed at ordinary income rates for taxpayers whose income exceeds $1 million ($500,000 for married taxpayers filing separately), indexed for inflation after 2022. While this proposal was previously announced during President Biden's campaign and widely expected the Treasury Department surprised observers by imposing this rate increase on "gains required to be recognized after the date of announcement," which is widely believed to mean April 28, 2021 (the date of the announcement of the American Rescue Plan). It remains to be seen whether the retroactive effective date will survive the legislative process, though there is reason to believe that Congress may not defer to Treasury's recommendation. In any event, full repeal or partial rollback of the rate preference for long-term capital gains and qualified dividend income would have profound ramifications for individual taxpayers, compounding the incentives to defer realization events for appreciated investments, increasing the economic value of capital losses and capital loss carryforwards, and bringing dividend-bearing equity investments closer to tax parity with interest-bearing debt investments.

Tax Carried Interests as Ordinary Income: Taxpayers with taxable income over $400,000 who perform services for an "investment partnership" and hold a profits interest in such partnership (an "investment services partnership interest") must pay tax at ordinary rates and self-employment taxes on their allocable share of income from that interest and on gains from the sale of that interest. A partnership is an investment partnership if (1) substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), and (2) over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business.

If the proposed repeal of the long-term capital gain preference is enacted, the effect of the carried interest proposal is likely to be limited. It would only affect taxpayers who have annual income between $400,000 and $1 million and earn at least some of that income from a profits interest in a certain kind of partnership; few people are likely to meet these criteria. In contrast, if the long-term capital gain preference survives, even in a limited form (for example, if the rate on capital gains increases to 30%), this proposal would have a significant impact on the tax treatment of carried interests and optimal planning strategies for many partnerships.

Treat Transfers of Appreciated Property by Gift or at Death as Realization Events: In what would be a transformational change to long standing existing law, donors and decedents would generally recognize gain on appreciated property transferred by gift or at death. The tax on gain realized at death would be deductible on the decedent's estate tax return. The extent to which losses could be recognized is unclear, as is the extent to which a decedent's loss carryovers could offset gains realized at death.

There are limited exclusions from gain recognition, including a $1 million exclusion per donor or decedent and exclusions for transfers to charities and U.S. spouses who take transferred property with a carryover basis. The payment of tax on illiquid assets transferred at death may be made based on a 15-year fixed-rate payment plan, and the payment of tax attributable to certain family-owned and operated businesses could be deferred until the business is sold or ceases to be family-owned and operated.

Transfers of property to and distributions of property from irrevocable trusts, partnerships and other noncorporate entities also would be treated as recognition events. In addition, trusts, partnerships and other noncorporate entities that own property must recognize gain on unrealized appreciation of that property if the property has not been subject to a recognition event in 90

years, starting January 1, 1940 — in other words, the first taxable events under this aspect of the proposal would happen on December 31, 2030.

Imposing tax on contributions of appreciated property to partnerships and on distributions of appreciated property from partnerships goes far beyond the elimination of basis step-up at death and, taken at face value, would upend longstanding principles of partnership taxation, such as Sections 721 and 731. Treasury officials have since indicated that this proposal was not intended to have such a broad impact. It therefore seems safe to assume that the application of this proposal to partnerships would be significantly limited or omitted altogether in future legislation.

Imposing income tax on transfers of appreciated property to trusts and on distributions of appreciated property from trusts, including many grantor trusts, could reduce the attractiveness of certain estate planning trusts, such as grantor retained annuity trusts (GRATs), and could have broad-ranging, perhaps unintended, consequences for common trust transactions (*e.g.*, the distribution of property from a trust to a beneficiary or from one trust to another upon the happening of a particular event).

The value of property subject to tax on a gift, death or other triggering event would generally be determined in accordance with estate and gift tax valuation principles, except that a "partial interest" in property would have a value equal to its proportionate share of the fair market value of the entire property. It is not clear what property would be considered a "partial interest" for this purpose.

Harmonize and Expand SECA and NIIT: The Green Book proposes to subject all pass-through business income of taxpayers with at least $400,000 of adjusted gross income to either the net investment income tax (NIIT) or Self-Employment Contributions Act (SECA) tax. To that end, the NIIT base would expand to include income and gain from trades or businesses not otherwise subject to employment taxes. In addition, certain S corporation owners, limited partners

and LLC members who provide services and "materially participate" in their businesses would be subject to the SECA tax on distributive shares above certain thresholds, subject to current-law exceptions for certain types of income (*e.g.*, rents, dividends, capital gains and certain retired partner income). The Green Book defines "materially participate" to mean regular, continuous and substantial involvement and says that this will "usually" mean at least 500 hours spent on the business per year. This is similar to the "500 hour" standard in the passive loss rules but not an explicit requirement. In short, these provisions would make it very difficult for high-income taxpayers who are partners in operating partnerships and provide services to those partnerships to avoid paying at least 3.8% on top of their typical income tax rates.

Limit Nonrecognition in Like-Kind Exchanges: The Green Book would limit eligibility for "like-kind" exchanges under Section 1031. Each taxpayer would be allowed to defer up to $500,000 of gain each year ($1 million for married taxpayers filing jointly) for like-kind exchanges of real property. Gains in excess of that amount would be recognized in the taxable year when the taxpayer transfers the real property. These changes would require REITs to distribute gains on property sales that could otherwise be deferred under Section 1031. Given timing rules under Section 1031 and the proposal's application to exchanges *completed* in taxable years beginning after December 31, 2021, this proposal may pick up many exchanges *beginning* in 2021.

Make Excess Loss Disallowance Permanent: The Section 461(l) disallowance of excess business losses for noncorporate taxpayers in taxable years would be made permanent.

801 West South Boundary | Suite C
Perrysburg, OH 43551
567.806.5200
chad.baker@bakerlawltd.com

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