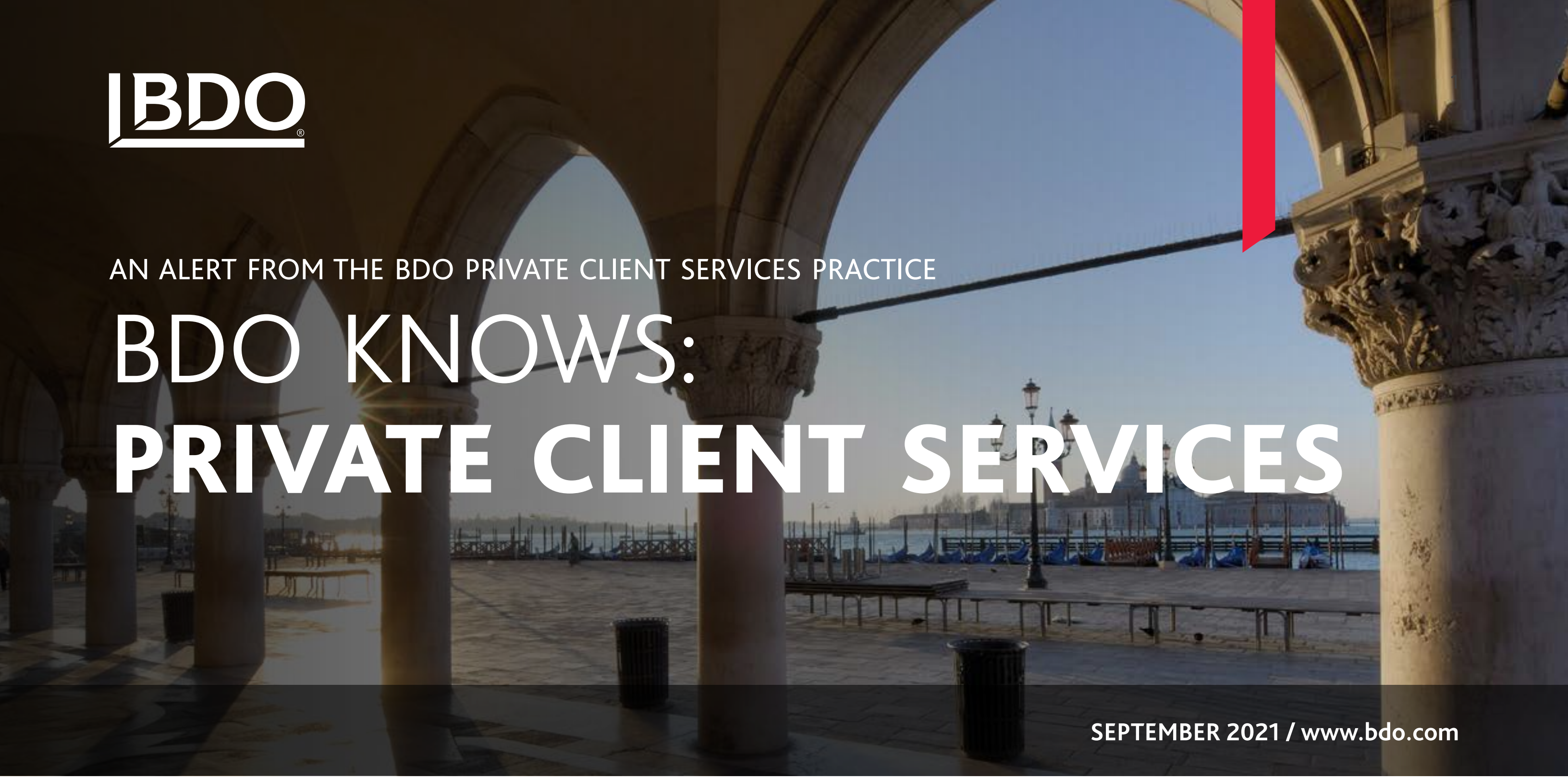

AN ALERT FROM THE BDO PRIVATE CLIENT SERVICES PRACTICE

BDO KNOWS: PRIVATE CLIENT SERVICES

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HOUSE WAYS AND MEANS COMMITTEE RELEASES INITIAL TAX PROPOSALS

On September 13, 2021, the House Ways and Means Committee released draft legislation that proposes a series of tax increases and tax cuts, which will undergo a round of markups by the committee over the next few days. Most tax proposals were anticipated; however, the Committee provided a few surprises.

INCOME TAX PROVISIONS

Section 1202 – Qualified Small Business Stock

Taxpayers are currently eligible for 75% and 100% exclusions for sales of qualified small business stock (QSBS). In an unexpected move, the proposed legislation would eliminate the 75% and 100% exclusions for sales of QSBS acquired after February 17, 2009, and sold after **September 13, 2021**, unless the sale was made pursuant to a written binding contract already in place and not materially modified thereafter. The proposed provision would apply to taxpayers whose adjusted gross income equals or exceeds $400,000 and to trusts and estates.

Under the current 50% exclusion rules, the remaining 50% QSBS gain is taxed at 28%. The excluded QSBS gain is considered an alternative minimum tax (AMT) preference item, which, when considered along with the net investment income tax on the taxable half of the gain, results in an effective rate of 16.88% for QSBS acquired after February 17, 2009, and sold after September 13, 2021.

Capital Gains

The current maximum tax rate on capital gains is 20%. The proposed legislation would increase the capital gains rate to 25% for taxable years ending **after September 13, 2021**. Transitional rules are proposed for taxable years that include September 13, 2021, taxing net gains realized before September 13, 2021, at 20%. Gains arising from a transaction pursuant to a binding written contract in effect before September 13, 2021, (and not materially modified thereafter) would remain eligible for the 20% rate.

Planning opportunity: Consider deferring realization of some capital losses until 2022 to offset capital gains that would otherwise be taxed at 25%.

Top Marginal Individual Income Tax Rate

The top marginal individual income tax rate now is 37%. The draft legislation would raise the top marginal tax rate to 39.6% for taxable income over $450,000 for married individuals filing jointly and surviving spouses, $425,000 for head of households, $400,000 for single individuals, $225,000 for married individuals filing separately, and $12,500 for estates and trusts. The proposal would be effective for taxable years beginning after December 31, 2021.

Planning opportunity: Consider accelerating ordinary income to 2021.

Net Investment Income Tax

Under the current rules, net investment income does not include income derived in the ordinary course of a trade or business or income attributable to the disposition of property earned outside of a passive activity. The proposed legislation would eliminate those carveouts and others, while broadening the type of income subject to net investment income tax (NIIT). NIIT applies to the greater of "specified net income" or net investment income for high income individuals, estates, and trusts. "Specified net income" includes net investment income even if derived in the ordinary course of a trade or business and other gross income and net gains attributable to the disposition of property, even if earned outside of a passive activity or the trade or business of trading financial instruments or commodities. Certain foreign income is includible in the definition of net investment income.

The proposed provision would apply to taxpayers whose modified adjusted gross income exceeds $500,000 for married individuals filing jointly and surviving spouses, $250,000 for married individuals filing separately, $12,500 for estates and trusts, and $400,000 for all other tax filers. The proposal would be effective for taxable years beginning after December 31, 2021.

Carried Interests

The holding period to obtain long-term capital gains treatment for gain allocated to carried interest partners is three years. The proposal would extend the holding period from three to five years. The three-year holding period would remain in effect with respect to any income attributable to real property trades or businesses and for taxpayers (other than an estate or trust) with adjusted gross income of less than $400,000. The proposal also contains provisions to include all items that are treated as capital gain (for example, Section 1231 gain) and prevent avoidance of the holding period rules. The proposal would be effective for taxable years beginning after December 31, 2021.

Qualified Business Income

The qualified business income deduction currently is not limited by a maximum allowable deduction. The proposal would introduce such a cap, limiting the maximum allowable qualified business income deduction to $500,000 for married individuals filing jointly and surviving spouses, $250,000 for married individuals filing separately, $10,000 for estates and trusts, and $400,000 for all other taxpayers. The proposal would be effective for taxable years beginning after December 31, 2021.

Excess Business Loss Limitation

Under a temporary provision, excess business losses (EBLs) of non-corporate taxpayers in excess of $500,000 for joint filers ($250,000 for all other taxpayers) are disallowed and treated as net operating losses in the following year; however, the provision is set to expire on December 31, 2026. The proposal would make the temporary provision permanent and modify how a disallowed EBL is treated. Instead of treating the disallowed loss as a net operating loss in the following year, the EBL would be treated as a deduction attributable to a taxpayer's trades or businesses when computing the EBL in the subsequent year. The proposal would be effective for taxable years beginning after **December 31, 2020.**

Surcharge on High-Income Individuals

There is currently no surcharge imposed on high-income individuals. The proposal would impose a 3% surcharge on modified adjusted gross income in excess of $2,500,000 for married individuals filing separately, $100,000 for estates and trusts, and $5,000,000 for all other individuals. The proposal would be effective for taxable years beginning after December 31, 2021.

Transfers Between Deemed Owner and Irrevocable Grantor Trust

Transfers between a deemed owner and his or her irrevocable grantor trust are nontaxable events. The proposal would disregard grantor trust status when determining whether a transfer between a deemed owner and his or her grantor trust is a sale or an exchange, possibly resulting in a taxable event. Additionally, the proposal would expand the definition of related party under Internal Revenue Code (IRC) Section 267(b) to include grantor trusts and their deemed owners. The proposal would apply to trusts created on or after the date of the enactment of this provision and to any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date.

Planning opportunity: Consider sales to intentionally defective grantor trusts.

ESTATE AND GIFT TAX PROVISIONS

Estate Tax Basic Exclusion Amount

The estate tax basic exclusion amount is $11,700,000 for 2021. The proposal would terminate the temporary increase in the basic exclusion amount, returning that amount to $5,000,000, indexed for inflation. Under this proposal, the basic exclusion amount in 2022 is anticipated to be $6,030,000. The proposal would apply to estates of decedents dying and gifts made after December 31, 2021.

Planning opportunity: Consider making gifts up to the 2021 estate tax basic exclusion amount, $11,700,000.

Grantor Trusts

When a deemed owner of a grantor trust dies, the assets of that grantor trust (other than a fully revocable trust) are generally not included in the deemed owner's estate. The proposal would require that assets in a grantor trust be included in the gross estate of the deceased deemed owner. Additionally, the proposal would treat distributions (other than to the deemed owner or spouse) during the life of the deemed owner and the termination of grantor trust status during the life of the deemed owner as completed gifts.

The proposal would apply to trusts created on or after the date of the enactment of this provision and to any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date.

Planning opportunity: Consider terminating grantor trust status for irrevocable life insurance trusts (ILITs) or making gifts to an intentionally defective grantor trust, a grantor retained annuity trust (GRAT), or spousal lifetime access trust (SLAT).

Valuation Discounts

Valuation discounts, such as marketability discounts and minority interest discounts, are allowed for transfers of nonbusiness assets for estate and gift tax purposes. The proposal would eliminate valuation discounts for certain transfers of nonbusiness assets for estate and gift tax purposes. Nonbusiness assets are defined as passive assets that are held for the production or collection of income and are not used in the active conduct of a trade or business. The proposal would apply to transfers after the date of the enactment of this Act.

Planning opportunity: Consider making gifts that will be eligible for valuation discounts.

RETIREMENT PLANS

Annual Contributions to Plans

Annual contributions to retirement plans are not currently limited by the value of the retirement plans owned by a taxpayer. The proposal would prohibit annual contributions by "applicable taxpayers" to "applicable retirement plans" (which includes tax-qualified defined contribution plans, IRC Section 403(b) and 457(b) plans, and traditional and Roth IRAs) if the total value of all the taxpayer's applicable retirement accounts exceeds $10 million as of the end of the prior year. Applicable taxpayers are head of household filers with adjusted taxable income in excess of $425,000, married individuals filing joint and surviving spouses with adjusted taxable income in excess of $450,000, and all other taxpayers with adjusted taxable income in excess of $400,000. Both the $10 million cap and income limitations are indexed for inflation beginning after 2022. The proposal would be effective for taxable years beginning after December 31, 2021.

Minimum Required Distributions from Plans

Taxpayers are not currently required to take additional distributions if the total value of their retirement plan accounts exceeds $10 million. The proposal would require applicable taxpayers (as defined above) of any age to take a minimum required distribution equal to 50% of the aggregate vested balances in applicable retirement plans in excess of $10 million. In other words, if an applicable taxpayer's combined retirement plan account balances exceed $10 million at the end of the taxable year, the taxpayer must take a minimum required distribution in the following year equal to 50% of the amount in excess of $10 million.

Further, if the taxpayer's combined retirement plan account balances exceed $20 million, the taxpayer would be required to take distributions equal to the lesser of (i) the aggregate plan balances in excess of $20 million or (ii) the aggregate balances in Roth IRAs and designated Roth accounts in defined contribution plans. Once the taxpayer distributes the amount of any excess required under this distribution rule, the taxpayer then would be allowed to determine the retirement accounts from which to make distributions in satisfaction of the 50% distribution rule.

The proposal would be effective for tax years beginning after December 31, 2021.

Roth Rollovers and Conversions

The current definition of a qualified rollover or conversion does not exclude any portion of the rollover or contribution that is not includible in gross income. The proposed legislation would amend the definition of qualified rollovers and conversions to Roth IRAs to include only amounts that would be includible in gross income and subject to tax. The proposal would be effective for rollovers and conversions made after December 31, 2021.

"Back Door" Roth IRAs

"Back door" Roth IRA strategies currently allow taxpayers who exceed existing Roth income limits to make nondeductible contributions to a traditional IRA, and shortly thereafter, convert the nondeductible contribution from the traditional IRA to a Roth IRA. Current law also allows taxpayers to contribute to a Roth 401(k) plan regardless of income limits (including making non-Roth after-tax contributions) and convert such contributions to a Roth IRA. The proposal would prohibit applicable taxpayers from engaging in these "back door" Roth IRA strategies.

To eliminate these strategies, the proposal would prohibit Roth conversions, for both IRAs and employer-sponsored plans, for applicable taxpayers, as defined above. The proposal would be effective for distributions, transfers and contributions made in taxable years beginning after **December 31, 2031** (10 years from now). However, for taxable years beginning after December 31, 2021, the proposal would prohibit all employee after-tax contributions in tax-qualified retirement plans and would prohibit after-tax IRA contributions from being converted to Roth IRAs regardless of income level.

IRAs and Accredited Investor

The proposed legislation would prohibit IRAs from holding any security that requires the IRA owner to be an accredited investor. This proposal would be effective for taxable years beginning after December 31, 2021, but with a two-year transition period for investments already held in an IRA as of the date of enactment.

IRAs and Self-Dealing

To prevent self-dealing, the proposal would expand the definition of "prohibited investments" in an IRA to include investments in which the IRA owner has a substantial interest. A substantial interest is defined as (a) a direct or indirect interest in investments not tradeable on an established securities market in which the IRA owner has at least 10% of the (i) combined voting power or value of all classes of stock, (ii) capital or profits interest of a partnership, or (iii) beneficial interest of a trust or estate; or (b) a corporation, partnership, or other unincorporated enterprise in which the IRA owner is an officer or director (or holds a similar position). The proposal makes this provision a requirement to be a valid IRA.

The proposal would be effective for investments made in taxable years beginning after December 31, 2021, but with a two-year transition period for investments already held in an IRA as of the date of enactment.

OTHER HIGHLIGHTS

The proposal also includes the following noteworthy provisions:

- Repeal of the temporary limitation on personal casualty losses.
- Expansion of the wash sale rules to include foreign currency, commodities, and digital assets. The rules also would apply to acquisitions by certain related parties including the taxpayer's spouse, dependents, taxpayers to whom the taxpayer is a dependent, entities controlled by the taxpayer or related party, 529 plans and Coverdell education savings accounts where a related party is the beneficiary, and certain 401(a), 403(a), 403(b), and 457(b) plans where the taxpayer or related party can make investment decisions.

COMMENT

The proposed legislation does not include a repeal of the $10,000 limit on the state and local tax deduction for individual taxpayers, nor does it include provisions to eliminate the step-up in basis upon death. It is unclear whether those provisions will be added to this proposed legislation or included in other legislation. Recent news reports suggest that these two provisions do not have solid support among Democratic leaders.

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