How Proposed Tax Changes May Affect You or Your Business

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On September 13, 2021, the House Ways and Means Committee released its long-awaited budget reconciliation proposal (the "House Proposal"). As anticipated, the House Proposal includes numerous tax rate increases and tax reforms. While many of the anticipated changes are included, a few notable changes are not; specifically, any limitations on like-kind real property exchanges, a repeal of capital gains tax rates with respect to "carried interest" (although carried interest was addressed in the House Proposal), and a repeal of the $10,000 cap on state and local tax deductions. Senate Democrats are still negotiating the topline of the reconciliation bill, with two Democratic Senators (Manchin (WV) and Sinema (AZ)) tapping the brakes, delaying a majority consensus in that body. Although the House Proposal is far from enacted law, and its final terms will have to reconcile with whatever action the Senate ultimately takes, it is the most comprehensive set of Congressional tax proposals yet. A brief overview of some of its key domestic components follows:

Individuals

- The highest marginal individual tax rate is increased to 39.6% (from 37%).
- The highest long-term capital gains tax rate is increased to 25% (from 20%). The House Proposal provides that the 25% rate is effective from the date of the House Proposal's release (Sept. 13), but provides that any gains with respect to a binding contract entered into prior to the House Proposal will be taxed at the 20% rate.
- Transactions between the grantor of a grantor trust and their grantor trust are treated as taxable sales between third parties, effective upon the enactment of the new law (not January 1, 2022).
- The net investment income tax is expanded to tax certain net investment income derived in the ordinary course of business for taxpayers with taxable income over $500,000 for married filing jointly and $400,000 for individuals.
- A 3% surcharge is taxed on income over $5,000,000 for married filing jointly or $2,500,000 for an individual filer.
- The House Proposal provides for a two-year period beginning after December 31, 2021, during which certain S Corporations formed before May 13, 1996, can convert to a partnership in a tax-deferred transaction.
- The unified credit will revert back to its $5 million level, adjusted for inflation, which will ultimately set the credit at approximately $6 million, effective as of January 1, 2022. Estate and gift tax rates might stay the same (i.e., no increase to 65% for certain estates).
- Elimination of marketability and minority discounts for transfers of passive investment assets, but retaining such discounts for active trades and business of the grantor.
- No capital gains tax on assets owned upon decedent's death—survival of step-up tax basis rules looks favorable.
- Limitations to gift tax exemptions to certain irrevocable trusts may have been averted.

Businesses

- The highest corporate rate is increased to 26.5% (from 21%).
- The pass-through qualified business income deduction under Section 199A is limited to $500,000 for married filing jointly and $400,000 for individual filers.
- The three-year holding period required for long-term capital gains tax on carried interest that was included in the 2017 Tax Cuts and Jobs Act is expanded to five years in the House Proposal (although the three-year holding period would still apply for transactions involving real property used in a trade or business and for taxpayers with adjusted gross income under $400,000). The House Proposal also expanded the types of assets that are subject to the longer holding period.
- The gain exclusion for Section 1202 qualified small business stock is limited to 50% (from an exclusion of either 100% or 75% under current law) for taxpayers with incomes over $500,000 for married filing jointly and $400,000 for individual filers. Like with the increase in long-term capital gains rates, the House Proposal causes this change to be effective on September 13 (subject to similar transition rules).

In addition to the above, there are numerous changes to the international tax rules applicable to businesses that are outside the scope of this alert.

Please contact any of the Lippes Mathias attorneys below for more information about this article.

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