How “Mean” Is the House Ways and Means Committee Tax Proposal?

On Monday, September 13, 2021, the House Ways and Means Committee released a draft of its proposed tax legislation and a summary of the major provisions. The proposed legislation, if enacted, would push higher tax rates on corporations, investors, and high-income business owners, limit several estate planning techniques (including some uses of grantor trusts and asset transfers with discounted values), and curtail perceived retirement plan abuses. A few of the provisions contained in the proposed legislation are described below.

Provisions Impacting Income Taxes

The proposed legislation contains several provisions which serve to increase income taxes, including the following:

- **Replacing the current flat corporate income tax rate of 21% with a graduated rate structure of 18% on taxable income up to $400,000, 21% on taxable income between $400,000 and $5,000,000, and 26.5% on taxable income above $5,000,000.** Incorporated businesses like law firms, accounting firms, and medical practices that are taxed as personal service corporations will be subject to a flat corporate income tax rate of 26.5%.
- **Creating a new 3% surtax on individuals with modified adjusted gross income in excess of $5,000,000 ($2,500,000 for married taxpayers filing separately).** The surtax applies to estates and trusts with modified adjusted gross income in excess of $100,000.
- **Increasing the top marginal income tax rate to 46.4%** (39.6% top individual income tax bracket, plus 3.8% net investment income tax, plus 3% surtax). This would apply to individuals having taxable income in excess of certain thresholds — $450,000 (married taxpayers filing jointly), $425,000 (individual taxpayers filing as head of household), $400,000 (single taxpayers), and $225,000 (married taxpayers filing separately). The 39.6% top income tax bracket applies to estates and trusts having taxable income in excess of $12,500. When combined with state and local taxes, the proposed federal tax rates could lead to certain taxpayers facing a combined tax rate as high as 61.2%.
- **Increasing the top capital gains rate to 31.8%** (25% statutory rate, plus 3.8% net investment income tax, plus 3% surtax). The proposed legislative text currently provides that any transactions completed on or before September 13, 2021, or subject to a binding written contract before September 13, 2021 (even if the transaction closes in the current tax year after September 13), are subject to the current 20% statutory rate. Capital gains recognized after the current tax year, regardless of the contract date, are proposed to be subject to the new 25% statutory rate.
- **Limiting the Section 199A qualified business income deduction** to $500,000 (married taxpayers filing jointly), $400,000 (single taxpayers and individual taxpayers filing as head of household), $250,000 (married taxpayers filing separately), and $10,000 (trusts and estates).
- **Applying the wash sale rule to cryptocurrency and other “commodities, currencies, and digital assets.”**

With the exception of the increase in capital gain rates as noted above, these changes are generally set to take effect for tax years beginning after December 31, 2021.

Provisions Impacting Estate and Gift Taxes and Grantor Trusts

The proposed legislation contains several provisions impacting estate plans, including the following:

- **Cutting the estate and gift tax lifetime exemption in half** from the current inflation-adjusted $10,000,000 per person ($11,700,000 in 2021) to an inflation-adjusted $5,000,000 ($5,850,000 based on the 2021 inflation rate). This reduction would apply to estates of decedents dying and gifts made after December 31, 2021.

- **Including all grantor trusts, created after the enactment of the legislation, in the taxable estate of the grantor.** Further, all distributions (other than to the grantor or the grantor's spouse) from grantor trusts created after the enactment of the legislation will be deemed as gifts to the beneficiaries. The legislation also looks to end a commonly used estate reduction technique of selling an asset to a defective grantor trust by taxing such sales the same way as the normal sale of assets to a third party. This provision applies only to trusts executed after the enactment of the legislation and subsequent transfers to grantor trusts.
- **Eliminating valuation discounts on "nonbusiness assets" transferred after the enactment of the legislation.**

Provisions Impacting Retirement Planning

The proposed legislation contains several provisions to curtail perceived retirement account abuses, including the following:

- **Prohibiting further contributions to Roth or traditional IRAs if the total value of an individual's IRA and defined contribution retirement accounts exceed $10,000,000 as of the end of the prior taxable year.** The limit on contributions would only apply to individuals having taxable income (indexed for inflation) in excess of certain thresholds — $450,000 (married taxpayers filing jointly), $425,000 (individual taxpayers filing as head of household), and $400,000 (single taxpayers and married taxpayers filing separately).
- **Imposing a new required minimum distribution requirement on high-income taxpayers with large retirement account balances.** Similar to the above proposal, if an individual's combined traditional IRA, Roth IRA, and defined contribution retirement account balances exceed $10,000,000 at the end of a taxable year, a minimum distribution would be required for the following year. This minimum distribution is only required if the taxpayer's taxable income exceeds the thresholds described above (e.g., $450,000 for a joint return). The minimum distribution generally is 50% of the amount by which the individual's prior year aggregate traditional IRA, Roth IRA, and defined contribution account balance exceeds the $10,000,000 limit. The proposed legislation also provides rules dictating from which account distributions must be made if the taxpayer's account totals exceed $20,000,000.
- **Closing so-called "backdoor" Roth IRA strategies by eliminating Roth conversions for both IRAs and employer-sponsored plans if the taxpayer's taxable income is above the thresholds described above** (e.g., $450,000 for a joint return). The bill also prohibits all employee after-tax contributions in qualified plans and prohibits after-tax IRA contributions from being converted to Roth regardless of income level.
- Disallowing IRA investments that require accredited investor status, with a two-year transition period for IRAs already holding these investments.

The above provisions generally take effect for tax years beginning after December 31, 2021, and seem to be a response to the ProPublica report indicating that PayPal co-founder Peter Thiel owns a Roth IRA that grew from $2,000 in 1999 to $5,000,000,000 in 2019.

While the legislation described above is in its infancy, a number of concessions are evident by the text. Some of the above changes may not make the final legislation; however, it seems reasonable that a number will remain, and we anticipate future articles detailing the surviving provisions as this legislation progresses.

If you have any questions or concerns about this proposed legislation and how it relates to you, please contact David Hunter, Nick Nester, or your relationship attorney for more information.