Treasury Department "Green Book" May 28, 2021
Summary of Significant U.S. Tax Proposals

Raise the Corporate Income Tax Rate

The current federal corporate income tax rate is 21%. The Green Book proposes to increase the income tax rate for C corporations to 28%, effective for taxable years beginning after December 31, 2021. For non-calendar year corporations, the 2021-2022 tax rate would be 21% plus 7% times the portion of the tax year that occurs in 2022.

Note: Recent comments by President Biden caused many to expect a proposed increase to 25%, rather than 28%, and it is possible that the Administration will agree to a smaller corporate tax rate increase.

Increase the Top Marginal Individual Tax Rate

The Green Book proposes to increase the top marginal individual income tax rate from 37% to 39.6% (before accounting for the additional 3.8% tax on net investment income), effective for taxable years beginning after December 31, 2021. In 2022, the top marginal tax rate would apply to taxable income over $509,300 for married individuals filing jointly, or $452,700 for single filers.

Note: This proposal would accelerate the return of the top income tax rate of 39.6%, which under current law would have occurred automatically for tax years after 2025.

Note: The Green Book is silent on the Section 199A pass-through deduction, which allows certain pass-through business owners to deduct up to 20% of their qualified business income, but this deduction may be repealed or limited by Congress to taxpayers with AGI not exceeding $400,000. The Green Book is also silent on the $10,000 cap on state and local (SALT) deduction, which may be repealed and replaced by Congress with limitations on itemized deductions for taxpayers earning more than $400,000.

Tax Long-Term Capital Gains and Qualified Dividends at Ordinary Rates for High Earners

Currently, individuals are subject to a 20% maximum rate on long-term capital gains and qualified dividends (plus 3.8% net investment income tax). The Green Book proposes to subject individuals' long-term capital gains and qualified dividends to a 37% ordinary income rate (40.8% including the 3.8% net investment income tax) to the extent that the individual's AGI exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022. For example, an individual with $200,000 of long-term capital gains and $900,000 of wages would have $100,000 of long-term capital gains taxed at ordinary income tax rates.

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This proposal would be effective for gains recognized after the date of announcement, which may mean the April 28, 2021 announcement of the American Families Plan or the May 28, 2021 release of the budget and Green Book.

Note: This potentially retroactive tax rate adjustment for capital gains is problematic for taxpayers who have completed transactions post-April 28th or are contemplating transactions in 2021. These rules may encourage taxpayers with incomes below $1 million to enter into installment gain transactions to reduce the amount of capital gains in any one year.

Note: The effective date could change during the Budget reconciliation process and based on history, the higher rate may end up applying to sales occurring on or after the date of enactment of the legislation. Also, Congress could settle on reducing the higher capital gains rate from 37% to something less.

Treat Transfers of Appreciated Property by Gift or on Death as Realization Events

Generally, taxpayers take into account increases and decreases in the value of their assets only at the time of a realization event, such as a sale. Currently, gifts and transfers upon death are not treated as taxable events, even though heirs generally take a "stepped up" fair market value basis on property they receive from a decedent, with no income tax due at that time.

Under the Green Book proposal, the donor or deceased owner of an appreciated asset would recognize capital gain upon a transfer to a donee or heir, as applicable, based on the asset's fair market value at the time of transfer. That gain would be taxable income to the decedent on the federal gift or estate tax return or on a separate capital gains return. The use of capital losses and carry-forwards from transfers at death would be allowed against capital gains income and up to $3,000 of ordinary income on the decedent's final income tax return.

Gains on unrealized appreciation also would be recognized by a trust, partnership or other "noncorporate entity" that is the owner of property if that property has not been subject to a recognition event within the prior 90 years. The look-back period begins January 1, 1940, and therefore the first possible recognition event for any taxpayer under this provision would be December 31, 2030.

The proposal also would treat otherwise tax-deferred contributions to, or distributions from, partnerships, trusts and other non-corporate entities as taxable events.

Note: The Green Book does not elaborate on this aspect of the proposal and clarification is needed, because taken literally the proposal would overturn the fundamental principles in partnership taxation that contributions to and distributions by partnerships generally are tax free.

Note: Under the current proposal, without further clarification the elimination of the step-up in basis also negatively impacts pass-through entities doing business as S corporations vs.

partnerships. Absent a single-owner S corporation situation, the prospect of double "income taxation" is possible in an S corporation structure, but potentially unlikely with a partnership structure.

The following exclusions would apply:

- Transfers by a decedent to a U.S. spouse or to charity would carry over the basis of the decedent.
- The $250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple.
- The proposal would also allow a $1 million per-person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death. The per-person exclusion would be indexed for inflation after 2022 and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $2 million per married couple).

Payment of tax on the appreciation of certain family-owned and -operated businesses would be deferred until the interest in the business is sold or the business ceases to be family-owned and operated. Also, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, excluding liquid assets such as publicly traded financial assets and transfers of businesses for which the deferral election is made.

The proposal generally would be effective beginning January 1, 2022.

Note: The proposal to tax a trust, partnership or other "noncorporate entity" on the value of its appreciated assets (i.e., investment assets or goodwill) after 90 years could potentially devastate privately-held enterprises that might need to raise capital to pay for this tax without an actual liquidity event, if they do not qualify as "family-owned businesses" eligible to defer payment of the tax.

Note: These changes would fundamentally alter estate planning that has been in place for decades. If this legislation is enacted, any taxpayer with a sizable estate should re-evaluate their gift and estate strategy. It may suggest that gains on highly appreciated property be realized gradually to take advantage of the rate differential on taxable incomes below $1 million rather than bunching these gains at the date of gift or bequeath. These changes could also create significant liquidity issues for estates with large amounts of unrealized appreciation. Further, based on the 90-year recognition period, Dynasty Trusts may need to be reevaluated.

Note: The estate tax and lifetime gift tax exemption is currently $11.7 million per person ($23.4 million for married couples), and the current estate tax rate on amounts in excess of the exemption amounts is 40%. President Biden stated during the presidential campaign that he would seek a reduction in the exemption amounts and an increase in the estate tax rate to 45%,

but the Green Book is silent regarding these expected changes that are still expected to be enacted this year.

Note: Treasury Secretary Janet Yellen has stated that elimination of the income tax-free step-up in asset basis at death is a priority for the Biden administration, but the proposal to impose capital gains taxes at death may ultimately not gain sufficient support in Congress.

Expand the 3.8% Medicare Tax

Currently, limited partners who materially participate in a partnership's business are not subject to self-employment tax, and S corporation members who materially participate in an S corporation's business are subject to self-employment tax only on "reasonable compensation" that they receive in their employee capacity. These individuals are also exempt from the 3.8% "net investment income tax", which currently generally applies to passive income and gains recognized by high-income taxpayers. The separate 3.8% "SECA" (Self-Employment Contributions Act) tax currently applies to self-employment earnings of high-income taxpayers. Both taxes are intended to fund Medicare and therefore are referred to as "Medicare" taxes.

The Green Book proposes to subject all trade or business income of individuals whose earned income exceeds $400,000 to the 3.8% Medicare tax, either through the net investment tax or the SECA tax. For such high earners the definition of net investment tax would be amended to include gross income and gain from any trades or businesses that is not otherwise subject to employment taxes, and S corporation owners who materially participate in the trade or business would be subject to SECA taxes on their distributive shares of the business's income to the extent that their earned income exceeds certain threshold amounts.

The exemptions from SECA tax provided under current law for certain types of partnership or S corporation income (e.g., rents, dividends, capital gains and certain retired partner income) would continue to apply to these types of income.

The proposal will only impact taxpayers with earned income exceeding $400,000 (not indexed for inflation) and would be effective for taxable years beginning after December 31, 2021.

Tax Carried Interests as Ordinary Income

Under current law, partnerships are generally able to issue a partnership interest to a service provider who then holds the interest as a capital asset, with the character of the partner's share of profits from be partnership being determined by reference to the character of the profits in the hands of the partnership. These equity grants may take the form of a "profits interest", which is referred to as a "carried interest" in the private equity context, an "incentive allocation" in the hedge fund context or a "promote" in the real estate context. Section 1061, enacted by the Tax Cuts and Jobs Act, limits the ability to recognize long-term capital gain with respect to

these profits interests by generally treating gain recognized with respect to certain partnership interests or partnership assets held for less than three years as short-term.

The Green Book proposes to tax certain partners at ordinary rates on income from, and gains from the disposition of, their carried interests, regardless of the character of the income at the partnership level, if their taxable income from all sources exceeds $400,000. The proposal would apply to profits interests held by persons who provide services to a partnership that is an "investment partnership", and such partners whose taxable income does not exceed $400,000 would continue to be subject to section 1061.

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

Note: If the separate proposal to tax long-term capital gains at ordinary rates for individuals with income exceeding $1 million is enacted, then this carried interest proposal would materially affect only carried interest holders with taxable income between $400,000 and $1 million.

Limit Deferral of Gain on Like-Kind Exchanges

Under Section 1031, owners of appreciated real property used in a trade or business or held for investment can defer gain on the exchange of the property for real property of a "like kind". The Green Book proposal would allow the deferral of gain only up to an aggregate amount of $500,000 ($1 million for married individuals filing jointly) each year for real property exchanges that are like kind. Any gains exceeding $500,000 ($1 million for married individuals filing jointly) during a taxable year would be recognized in the year the taxpayer transfers the real property subject to the exchange.

The proposal does not index the exclusion amounts for inflation, although it does apply those amounts on an annual basis, and would be effective for exchanges completed in taxable years beginning after December 31, 2021.

Note: Additional clarity is needed regarding the effective date because taxpayers using Section 1031 have a maximum of 180 days from the date they sell to invest the net proceeds from the sale into replacement real estate. Therefore, exchanges that start in 2021 could be capped if they are completed in 2022, with any excess gain potentially subject to the new ordinary tax rate on capital gains, assuming both proposals become enacted into law. Congress may agree to taxpayer-friendly transition rules for sales completed before the date of enactment where title to replacement property is obtained after date of enactment.

Make Permanent Excess Business Loss Limitation of Noncorporate Taxpayers

The Tax Cuts and Jobs Acts requires that "excess business losses" be carried forward as net operating losses rather than deducted currently. An excess business loss is defined as the excess of losses from business activities over the sum of gains from business activities and a specified

threshold amount ($524,000 for married individuals filing jointly and $262,000 for all other taxpayers).

Under current law the excess business loss limitation expires in 2027, and the Green Book proposes to make this provision permanent.

Contact Us

We will continue to monitor developments related to these proposed tax changes and communicate any significant changes that will impact our clients. For more information, please contact your Bennett Thrasher tax advisor by calling 770.396.2200.

The above information is general in nature and should not be relied upon for any specific tax implication or investment decision. Actual results may differ, and readers are cautioned not to place reliance on these general observations. Consult with your adviser or counsel before undertaking any specific action.