House Ways and Means Committee Summary of Democratic Tax Proposals as of September 14, 2021

On Monday September 13, 2021, House Ways and Committee Chairman Richard Neal released the first draft of the House Democrats' tax legislation (including both tax increases and tax relief) they expect to consider as part of the budget reconciliation process, intended to fund key programs under President Biden's "Build Back Better" program. The proposed changes could result in more than $2 trillion in new federal revenue over the next 10 years, mainly supported by additional payments from high-income households and U.S. companies, according to initial estimates provided by the Joint Committee of Taxation (JCT). The initial provisions of the proposed legislation are highlighted below. Note that although Democrats can pass the proposals without Republican support as part of the budget reconciliation process, amendments to the proposals are likely, given that the support of moderate Democrats is needed to pass the bill. At present, it is anticipated that moderate members of the House and Senate will require a reduction in the proposed spending and tax increases to support the bill.

Individual Tax Proposals

Increase the Top Marginal Individual Tax Rate

The House Ways and Means (HWM) proposal increases the top individual tax rate from 37% to 39.6% The increased marginal rate applies to married individuals filing jointly with taxable income over $450,000, to heads of households with taxable income over $425,000 and to unmarried individuals with taxable income over $400,000.

Increase the Top Capital Gains Rate

The HWM proposal retroactively increases the current top rate on capital gains and qualified dividend income from 20% to 25%. Including the separate 3.8% net investment income tax, the top rate would increase to 28.8%.

- The capital gains rate increase is proposed to be effective for tax years ending after the date of introduction (September 13, 2021). The current statutory rate of 20% continues to apply to capital gains and qualified dividend income for the portion of the tax year on or before September 13, 2021.
- Gains recognized in the tax year from transactions pursuant to a written contract (and not materially modified) entered into on or before September 13, 2021 are treated as executed prior to the introduction date.

Expansion of Net Investment Income Tax (NIIT)

The HWM proposal expands the net investment income tax to cover net income derived in the ordinary course of a trade or business (that are not wages or already subject to NIIT) for taxpayers (including income from passthrough businesses and for trusts and estates) with greater than $400,000 in taxable income (single filer) or $500,000 (joint filer) effective for tax years beginning after December 31, 2021.

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Limitation on IRC Section 199A Deduction (Qualified Business Income Deduction)

The HWM proposal changes the allowable IRC Section 199A deduction (20% deduction of qualified business income) by limiting the maximum allowable deduction to $500,000 in the case of a joint return and $400,000 for an individual return.

Adjusted Gross Income Surtax

The HWM proposal includes an additional 3% surtax on individuals, trusts and estates with modified adjusted gross income -- defined for this purpose as adjusted gross income reduced by any deduction allowed for investment interest (as defined in Section 163(d)) -- in excess of $5 million ($2.5 million for a married individual filing separately; $100,000 for an estate or trust) for tax years beginning after December 31, 2021.

Carried Interest

The HWM proposal increases the holding period for which a taxpayer must qualify for capital gains treatment from three to five years. The HWM proposal also makes other changes that relate to complex structures to prevent taxpayers from avoiding these holding period rules. Note that by defining the five-year requirement to the later of the holding period for the partnership interest and the date on which substantially all of the assets of the partnership are held, the carried interest proposal potentially eliminates the ability of many investment funds to obtain the benefits of carried interest.

- The three-year holding period requirement would still apply to taxpayers with an adjusted gross income of less than $400,000 or for income that is attributable to a real property trade or business.
- Additionally, the scope of the carried interest provision would be expanded to capture all income that is treated as capital gains or subject to tax at the capital gain rate (which would capture section 1231 gains and qualified dividend income).

Qualified Small Business Stock Gain Exclusion

In general, Section 1202 allows taxpayers who invest in certain types of startup businesses to exclude up to $10 million of gain or 10 times their basis in the stock, provided they have held the shares for five years. The HWM proposal limits exclusion for taxpayers with adjusted gross income of at least $400,000 to no more than 50% of the gain realized. This provision is also retroactive, similar to the capital gains rate, so that it would apply to sales or exchanges after September 13, 2021, subject to a binding contract exception.

Limitation on Excess Business Losses for Non-Corporate Taxpayers

The Tax Cuts and Jobs Act ("TCJA") created a limitation on the ability of non-corporate taxpayers to use business losses against non-business income. Current law provides that a taxpayer can offset up to $500,000 (as adjusted for inflation) of business losses against non-business income. This provision under the TCJA was scheduled to sunset after December 31, 2027, as modified.

The HWM proposal removes the sunset provision thereby permanently extending the partial disallowance of business losses to offset non-business income.

High Net Worth (Individual Retirement Account) IRA Contributions

The HWM proposal prohibits high-income taxpayers from contributing to their IRA once their IRA and defined contribution account balances reach $10 million. The proposal would also require distributions once the value of the assets in IRA, Roth IRA and defined contribution accounts reaches certain levels. These provisions would be effective tax years beginning after December 31, 2021.

Estate and Gift Provisions

Expiration of Estate and Gift Tax Exemption

The HWM proposal accelerates the expiration of the current estate and gift tax exemption from December 31, 2025 to December 31, 2021. The unified credit would revert to its 2010 level of $5 million per individual, indexed for inflation.

Grantor Trust Modifications

In general, the grantor (person who contributes the assets to the trust) exerts sufficient control over the trust so that they are considered to earn income from the trust directly. The HWM proposal modifies current grantor trust rules to closely resemble existing income tax rules. Specifically, the proposal includes the grantor trust in the grantor’s estate at death and treats sales between grantor trusts and the grantor as a recognized transaction between unrelated third parties. The provisions would apply to trusts created on or after the date of enactment 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.

Estate Tax Valuation Changes

The HWM proposal modifies the estate valuation rules to ignore partial ownership and lack of control discounts. At present, this rule applies only to assets that are not used in a business. This provision is limited to passive assets, so such discounts are still permitted for family farms and businesses in the same way as current law.

Corporate and International Tax Proposals

Corporate Income Tax Rate Increase

The HWM proposal increases the U.S. corporate tax rate from 21% to 26.5% for businesses with income in excess of $5 million. A new 18% corporate tax rate is proposed for businesses with income below $400,000; businesses with income of at least $400,000 but less than $5 million would remain subject to the 21% rate. The benefit of the graduated rate phases out for corporations making more than $10 million. The proposed corporate tax rate changes would be effective for tax years beginning after December 31, 2021. Note that the current HWM proposal does not include a minimum tax based on book income as contained in President Biden's current Green Book proposal.

Interest Deduction Limitation/Strengthening of Earnings Stripping Rules

Effective for tax years after December 31, 2021, the HWM proposal limits the interest deduction of certain domestic corporations in proportion to their share of the total earnings of their international financial reporting group. This prevents multinational corporate groups from shifting a disproportionate amount of their interest deduction to the United States in order to lower their U.S. tax liability.

Modifications to the Global Intangible Low-Taxed Income (GILTI) Inclusion Rules

The HWM proposal increases the current GILTI rate from 10.5% to 16.5625% (via a reduction of the IRC Section 250 deduction, which currently permits a 50% deduction against GILTI income down to 37.5% and an increase to the corporate income tax rate as discussed above), and GILTI would be applied on a per-country basis. In determining foreign source income, only the IRC Section 250 deduction is allocable against GILTI income (i.e. interest and stewardship expenses are no longer allocated against GILTI income/basket nor reduce the GILTI foreign tax credit limitation). The proposal would be generally effective for tax years of foreign corporations beginning after December 31, 2021 and to the tax years of U.S. shareholders on which or with which such tax years of foreign corporations end. A transition rule is provided for tax years that include but do not end on December 31, 2021.

In addition, the proposal amends GILTI to allow for carryover of net tested losses and reduces the foreign tax credit haircut on GILTI from 20% to 5% (0% for U.S. territories). Any excess foreign tax credits could be carried forward five years with no opportunity for carryback. Moreover, the HWM proposal would allow a qualified business activity income (QBAI) exemption of 5% generally and 10% in U.S. territories.

Modifications to the Base Erosion Anti-Abuse Tax (BEAT)

The proposal amends the BEAT rate under current law as follows: the BEAT rate is amended to 10% in tax years beginning after December 31, 2021, and before January 1, 2024; to 12.5% in tax years beginning after December 31, 2023, and before January 1, 2026; and to 15% in any tax year beginning after December 31, 2025. The proposal further eliminates the base erosion threshold for taxable years beginning after January 1, 2024.

Similarly, the HWM proposal broadens the BEAT base by including inventory payments but provides an exemption for payments subject to sufficient foreign taxes (i.e. an effective rate of foreign tax that is greater than the BEAT rate) while removing the disallowance of tax credits under the BEAT rules and modifies the treatment of net operating losses for BEAT purposes.

Modifications to Foreign Derived Intangible Inclusion Rules (FDII)

Under current law, domestic corporations are allowed a deduction for 37.5% of its FDII with the applicable percentage being reduced to 21.875% for taxable years beginning after December 31,

2026. The HWM proposal reduces the deduction from 37.5% (current) to 21.875%. This reduction is scheduled to occur in taxable years beginning after December 31, 2025, so the proposal would be an acceleration of that scheduled reduction. The deemed tangible income return (FDII version of QBAI) remains at 10%.

Business Interest Deduction Limitation

The HWM proposal modifies the IRC Section 163(j) business interest deduction limitation so that it applies at the partner or S-corporation shareholder level, as opposed to at the entity (partnership or S-corporation) level. In addition, the proposal limits the IRC Section 163(j) disallowed business interest expense carryforward to five taxable years (rather than indefinitely) for a carryforward arising in a taxable year beginning after December 31, 2021.

Foreign Tax Credit Limitation

The HWM proposal would determine a U.S. shareholders foreign tax credit limitation for all baskets on a country-by-country basis, thereby limiting the use of excess foreign tax credits from high-tax jurisdictions to offset income inclusions from lower tax jurisdictions. In addition, the proposal would repeal the separate limitation category for foreign branch income.

Dividends from Foreign Corporations

The HWM proposal would limit the IRC Section 245A (dividends received deduction) to dividends received from CFCs rather than specified 10% foreign-owned corporations, applying on distributions made after enactment of the legislative changes.

Other Provisions

Cryptocurrency/Wash Sale and Disguised Sale Rule Modification

The HWM proposal modifies the wash sale rules to include commodities, currencies and digital assets and applies an anti-abuse rule previously applicable to stock and other securities, effective for tax years beginning after December 31, 2021. Additionally, the proposal amends the rules related to constructive sales to include digital assets and to apply anti-abuse rules previously applicable to other financial assets. Specifically, this includes transactions involving cryptocurrency to treat crypto the same as other financial instruments and prevent taxpayer abuse.

Executive Compensation (IRC Section 162(m))

The HWM proposal accelerates to 2022 the change in the American Rescue Plan to the limitations on the deduction of compensation above $1,000,000 for publicly held companies. The legislation also would expand the scope of the limit to compensation paid by other entities to the covered employees. Under the American Rescue Plan Act enacted earlier this year, the Section 162(m) limitation was broadened to include the top five compensated employees in addition to the CEO, CFO and three highest paid officers.

Conservation Easements

The HWM proposal modifies existing rules related to conservation easements by limiting deductions claimed by investors in “syndicated conservation easement” transactions, generally effective for contributions after December 23, 2016 (the date of the relevant IRS Notice). In the case of contributions of easements related to the preservation of certified historic structures, the proposal applies to contributions made in tax years beginning after December 18, 2018.

Research and Experimental Expenditures

Existing law calls for the capitalization and amortization of research and experimental expenditures beginning after December 31, 2021. The HWM proposal defers the implementation date of this rule until years beginning after December 31, 2025, thereby continuing to allow current deductibility of research and experimentation costs until then.

Tax Relief Efforts

Expanded Tax Credits

The HWM proposal expands the expanded child tax credit monthly benefit through the end of 2025. In addition, the proposal makes the earned income tax credit and the child dependent care tax credit permanent.

The legislation also would make permanent the new market tax credit and would modify and expand the historic rehabilitation tax credit, the low-income housing tax credit and certain other infrastructure-related tax credits.

The legislation also creates a new general credit for emerging technologies and provides a new credit for qualifying commercial electric vehicles as well as a new credit for plug-in electric vehicles purchased by individuals; the credit for qualifying individuals would be subject to income limits ($800,000 for joint returns/$400,000 for single returns).

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.