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Rockefeller Insights

Anchors Down: The Administration Holds Steady with a Plan, a Budget, and a Green Book

In the past two months, we have seen a flurry of activity in Washington, D.C., beginning with the American Families Plan released on April 28, 2021, followed by an address on that plan by President Biden to the joint session of Congress. A month later (May 28, 2021), the Biden Administration announced their Fiscal Year 2022 budget proposal along with the Treasury's "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," commonly known as the Green Book. The Green Book summarizes the budget proposals and, importantly, tallies up each provision's resulting revenue increase or loss.

Last week, President Biden announced a deal was reached on "traditional infrastructure" with a group of bipartisan Senators known as the "Group of 10." The Group consists of five Republicans (Collins, Cassidy, Murkowski, Portman, Romney) and five Democrats (Manchin, Shaheen, Sinema, Tester, Warner).

The Group of 10 has submitted a draft to the Administration for a $1.2 trillion package over eight years, representing $580 billion in new spending. As proposed, the package will be paid for primarily by unused COVID relief funds, unused unemployment insurance, sales from the Strategic Petroleum Reserve, and more strict compliance enforcement by the IRS. The Group does not propose any tax increases.

While the agreement among the Group of 10 is a great start to the "traditional infrastructure" negotiations, it remains to be seen whether it will actually get over the finish line. Regardless of whether the "traditional infrastructure" bill remains separate and ultimately passes independently, the Biden Administration is committed to legislation that includes "human infrastructure" provisions focusing on health care, child care, education, clean energy, and tax cuts for American families.

The "human infrastructure" bill, whether ultimately folded in with the "traditional infrastructure" bill or as a standalone bill, will almost assuredly include tax increases on the wealthy and as a result, will be met with fierce opposition by Republicans. Knowing this, Democrats in Congress will have to use the budget reconciliation process to pass such a "human infrastructure" bill on a strict party-line basis. As expected, Elizabeth McDonough, the Senate parliamentarian, recently added to her earlier ruling that another use of reconciliation for spending during the 2021 fiscal year would require a new budget resolution to be approved by the Senate Budget Committee. However, the committee is split evenly between Democrats and Republicans, and without GOP support, another resolution is improbable. Therefore, an infrastructure package using reconciliation will have to wait until the 2022 fiscal year starts on October 1, 2021. Democrats will likely begin drafting the bill this summer, and we may get some insights along the way.

In sum, we continue to float in a choppy sea of proposals with no real calm on the horizon. But with the introduction of the American Families Plan and the 2022 Fiscal Year Budget and Green Book, the Administration is firmly signaling their anchored position on increasing tax revenues from corporations and the wealthy. The remainder of this paper focuses on outlining the provisions laid out in these new proposals and their potential effects on individuals and privately held businesses.

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American Families Plan

On April 28, 2021, the Biden Administration outlined the key provisions of the American Families Plan. President Biden gave a speech to the joint session the next day, emphasizing increased taxes and robust social programs and infrastructure. The plan contained provisions focused on education, health care, childcare, and other items that fall under the umbrella of what the Administration calls "human infrastructure." Additionally, the plan included tax provisions to help pay for these initiatives that the administration estimates will raise $1.5 trillion over ten years. While the proposal represented only the beginnings of negotiations and contained tax provisions largely in line with expectations, it was a meaningful step in the process of enacting any tax law changes.

Key Tax Highlights of the American Families Plan

- Increase the top tax rate on ordinary income to 39.6%.
- Increase the capital gain and qualified dividend tax rate to 39.6% for "households" making over $1 million. The fact sheet for the plan did not specify how the $1 million threshold would be applied (e.g. taxable income vs. adjusted gross income, married filing jointly vs. single etc.), as well as what would be considered a "household."
- Eliminate the step-up in basis upon death for unrealized appreciation in excess of $1 million per taxpayer ($2.5 million per couple when combined with the existing principal residence capital gain exclusions). The fact sheet contained language suggesting carve-outs to shelter family-owned businesses and farms passing to heirs who continue to run the business, as well as contributions to charity. The proposal would, in effect, treat death as a "realization event" for capital gain purposes.
- Eliminate the ability for taxpayers to defer gains using like-kind exchanges of real estate where the gain is in excess of $500,000.
- Restrict the ability to treat carried interest gains as capital gain income subject to preferential tax rates and, instead, tax them at ordinary income rates. It is worth noting that carried interest gains would be taxed predominantly at ordinary income rates in any event if tax law changes included the proposed increase to the capital gains rate for "households" making over $1 million. This provision could ensure that any future reduction in capital gains rates does not benefit allocations of carried interest or might be included in the event the final proposal includes an increase in the capital gains tax rate that is somewhere below the top ordinary income tax rate.
- Notably, the plan did not include specific provisions for limiting itemized deductions, repealing the $10,000 SALT deduction cap, or reducing the estate, gift, and generation-skipping transfer tax exemption amounts prior to the scheduled sunset in 2026 (and raising the tax rate on these transfer taxes). All items that have received attention the past several months.
- Broaden the 3.8% Medicare surtax application to all individuals making over $400,000 (ending carve-outs for active income earned through pass-through entities and real estate professionals).
- Allocate additional funding to the IRS to enhance compliance enforcement, additional information reporting requirements, and regulation.
- The plan did not specify the intended effective date for any of the proposed provisions.

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The American Families Plan served as a clear signal of the White House's intent to increase taxes on the wealthy, but it also left taxpayers with many unanswered questions. The Budget Proposal and Green Book released last month helped to provide some clarity and formalize concepts found in the American Families Plan.

Budget Proposal and Green Book

On May 28, 2021, the Biden Administration released the Fiscal Year 2022 Budget, and the "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," which is commonly referred to as the "Green Book." The Green Book summarizes the Administration's tax proposals contained in the Budget.

Key Corporate Tax Highlights

- **Corporate Income Tax Rate** – Raise the income tax rate on C Corporations from 21% to 28%, effective for taxable years beginning after 12/31/21. For taxable years beginning after 1/1/21 and before 1/1/22, the tax rate would be 21% plus 7% times the portion of the tax year that occurs in 2022.

- **Global Minimum Tax Regime** – Minimum Tax on Book Earnings of Large Corporations of 15% on worldwide book income. The change would be applicable to corporations with book income in excess of $2 Billion and would be effective in tax years beginning after 12/31/21.

Key Individual Tax Highlights

- **Top Marginal Income Tax Rate & Threshold for the Top Rate** – Raise the top marginal rate from 37% to 39.6% and lower the taxable income threshold for the top rate as outlined below.

  Effective for tax years beginning after 12/31/21:
  - Married filing Joint: from $628,300 to $509,300
  - Single: from $523,600 to $452,700
  - Head of household: from $523,600 to $481,000
  - Married filing separate: from $314,150 to $254,650

  The current lower rate and higher thresholds are already scheduled to sunset after 12/31/25 under the terms of the TCJA. After 2022, the threshold above would be adjusted for inflation.

- **Capital Gains/Qualified Dividend Tax Rate** – Raise the tax rate on long-term capital gains and qualified dividends from the current maximum rate of 20% (23.8% including the net investment income tax) to a new maximum of 39.6% (43.4% including the net investment income tax). Effective for gains recognized "after the date of announcement" (arguably April 28, 2021). After 2022, the adjusted gross income thresholds would be adjusted for inflation. This change would apply to individuals with adjusted gross incomes (not taxable income) in excess of:
  - Taxpayers (other than those who file married filing separate): $1,000,000
  - Taxpayers who file married filing separate: $500,000

  Note that the ordinary tax rate would apply only to the portion of capital gain/qualified dividends over the $1MM (or $500K) threshold. For example, if a taxpayer had wages of $900,000 and capital gains of $200,000, he or she would pay $100,000 of capital gains at the preferred rate and $100,000 of capital gains at the ordinary rate.

- **Gifts or Inheritances** – Gratuitous transfers of appreciated property (by gift or at death) would be treated as realization events subject to capital gains tax. The changes to gifts and inheritances would be effective for individual transfers by gift or death after December 31, 2021. The changes to property owned by trusts, partnerships, and other non-corporate entities would become effective on January 1, 2022.
  - Gifts of appreciated property <u>during life</u> would result in the Donor realizing a capital gain equal to the excess of the fair market value (FMV) of the property over the Donor's basis in the asset.
  - Gifts of appreciated property <u>at death</u> would result in the Donor's estate realizing a capital gain equal to the excess of the FMV of the property over the Donor's basis in the asset. The income tax paid by the Donor's estate would be deductible on the Donor's estate tax return.
  - Transfers of property into a trust (other than a wholly-owned revocable grantor trust), partnership, or other non-corporate entity would be a recognition event.
  - Transfers of property from a trust (other than a wholly-owned revocable grantor trust), partnership, or other non-corporate entity would also be a recognition event.
  - Transfers of property from a wholly-owned revocable grantor trust to someone other than the grantor or his/her spouse would also be a recognition event.
  - A recognition event would occur whenever a revocable grantor trust becomes irrevocable because of the death of the grantor or otherwise.
  - Exclusion Amount:
    - Each person would have the ability to exclude a portion of the gain during life and/or at death.
    - Such exclusion would be $1MM per person and would shield the recognition of unrealized capital gains on property transferred by gift or held at death.

- Special Rules
  - No discounts for gifts of partial interests.
  - The $1MM per person exclusion would be indexed for inflation beginning in 2022.
  - The unused portion of a person's $1MM exclusion would be portable to a decedent's surviving spouse.
  - The payment of tax on the appreciation of certain family-owned and operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated.
  - The payment of tax due to appreciated assets being transferred <u>at death</u> could be paid over a 15-year period. Except for the tax due on the appreciation of liquid assets.
  - A deduction would be allowed for the costs of the appraisals of appreciated assets.
  - Another open question is whether the above rules would be applicable to transfers to and from S corporations, as they are not specifically mentioned in the Green Book.
- Excluded transfers/items:
  - Transfer to spouse – spouse would take carryover basis, and gain would be recognized when the spouse sells or dies.
  - Transfer to charity – would not generate a taxable gain.
    - Special rule for split-interest trusts: the transfer to trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain.
  - Tangible personal property (except for collectibles) would be excluded from recognition.
  - $250k exclusion on the gain on <u>all</u> residences (not just principal residences).
    - This would be portable to a decedent's surviving spouse, so the exclusion is effectively $500K per married couple.
  - Gain on the sale of small business stock (presumably Section 1202 Qualifying Small Business Stock)
- Basis of Received Property in the hands of the Donee.
  - At Death: Fair Market Value at death.
  - During Life: Carryover basis, increased by the amount of the gain recognized by the Donor that is not shielded by his/her $1MM exclusion.

- **Deemed Recognition Events Every 90 Years -** If property held in a trust, partnership, or other-non corporate entity has not been subject to a recognition event within the prior 90 years, there would be a deemed recognition event for such taxpayer upon the 90th anniversary.

  - The above 90-year testing period would begin on 1/1/1940, with the 1st gain being recognized on 12/31/2030.

- **Net Investment Income Tax and Self Employment Tax** – All trade or business income of taxpayers whose adjusted gross income is more than $400,000 would be subject to the 3.8% Medicare tax either through the net investment income tax rules or through self-employment taxes. This change would be effective for tax years beginning after December 31, 2021.
    - Limited Partners and LLC Members who (i) provide services and (ii) materially participate in the entity would be subject to self-employment taxes on their flow-through income from the partnership and/or LLC to the extent their income exceeds certain thresholds.
    - S Corporation owners who materially participate in the business would be subject to self-employment taxes on their flow-through income from the S corporation to the extent their income exceeds certain thresholds.
    - Special Rules:
        - Certain types of partnership, LLC and S corporation Income currently exempt from self-employment tax would remain exempt under the new rules.
            - These income items include rents, dividends, capital gains, and retired partner income.
        - The $400,000 threshold amount in the calculation would not be indexed for inflation.
        - The statutory exception to the self-employment tax for limited partners would not exempt a limited partner if they materially participate in the partnership.

- **Like-Kind Exchanges Under Section 1031** - There would be a cap on the annual amount of the gain that can be deferred on like-kind exchanges. This change would be effective for tax years beginning after December 31, 2021.
    - The cap would be $500K for each taxpayer ($1MM in the case of married individuals filing joint returns) each year.
    - Any gains in excess of $500K/$1MM each year would be taxable in the year the taxpayer transfers the real property subject to the exchange.

- **Excess Business Loss Limitation** – Makes permanent the inability of non-corporate taxpayers to deduct "excess business losses," which was previously set to sunset on 12/31/2026. This change would be effective for tax years beginning after December 31, 2026.
    - For 2021, "excess business loss" is defined as the excess of losses from business activities over the sum of (a) gains from business activities and (b) $524,000 for married filing joint taxpayers and $262,000 for all other taxpayers.
    - These numbers would be indexed for inflation for future tax years.

- **Taxation of Carried (Profits) Interest** – If a partner's taxable income (from all sources) exceeded $400,000, such partner's share of income on an "investment services partnership interest" in an investment partnership would be taxed as ordinary income instead of capital gains, regardless of the character of the income at the partnership level. This change would be effective for tax years beginning after December 31, 2021.

    - In addition, such partners in such investment partnerships would pay self-employment tax on such income.
    - The sale of an "investment services partnership interest" would also be taxed as ordinary income, not as capital gain, if the partner's taxable income exceeds $400,000.
        - There would be exceptions to the ordinary income treatment where the business has goodwill or other assets unrelated to the services of the partner.
    - Special Rules:
        - "Investment Services Partnership Interest" would mean a profits interest in an investment partnership that is held by a person who provides services to the partnership.
        - "Investment Partnership" would mean a partnership whose assets substantially consist of investment-type assets, but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business.
        - To the extent (1) a partner contributes money or other property to the partnership (not just services) ("invested capital") and (2) such partner's invested capital is treated similar to other partners who do not provide services to the partnership, income attributed to the invested capital would not be recharacterized as ordinary income.
            - Similarly, any gain recognized on the sale of a partnership that is attributable to the invested capital would also be capital gain.

Notable Omissions from the Biden Administration's Tax Proposals

The American Families Plan, the budget proposal, and the Green Book include and discuss numerous potentially drastic changes to the tax laws of the United States. What is not included and discussed is also very notable and impactful on tax planning.

Despite pledging during his campaign to increase the estate tax, the Biden administration's tax proposals make no mention of an increase to the estate or gift tax. While not 100% indicative of what will be in any final bill, the omission of such proposals is noteworthy since Biden had made taxing the wealthy such a major part of his campaign and presidency.

Equally noteworthy is the omission of any proposal regarding the current $10,000 cap on the deduction for state and local taxes (the "SALT deduction"). While not directly related to increasing taxes on the wealthy, not raising or eliminating the cap on the SALT deduction is notable since many viewed the imposition of the $10,000 SALT deduction cap as a politically motivated attack on democrats.

It is also worth highlighting that to date, none of the proposals have included provisions to limit the ability further for wealthy individuals to claim itemized deductions. Many expected to see proposals to re-introduce the "Pease Limitation" which effectively phases out a portion of some deductions for high income taxpayers, and/or the introduction of a new measure that would restrict high income taxpayers' ability to fully offset income taxed at the highest marginal rates with itemized deductions. As it stands, those proposals are yet to resurface in formal discussions.

What We are Watching

Notwithstanding the notable omissions described above, most of the items introduced in the American Families Plan, Budget, and Green Book tie directly to the proposals and ideas we have seen previously from the Biden Administration. With estimated revenue numbers now outlined, the picture is growing clearer on what the Biden Administration will anchor around in negotiations as we move through the summer.

Potentially, the most impactful item in the proposals for individual taxpayers is the increase in capital gains rates to 39.6% for individuals with an AGI over $1 million. This proposal is not new, but the focus has shifted in two ways from the original proposals made by the Biden Campaign last year. First, the Biden Administration is, at least, suggesting from a budgetary stance that the increase would occur at the proposal of the initiative, which was April 28, 2021 (retroactive to April of this year). Second, the connection between capital gains and the elimination of the step-up in basis creates a material revenue estimate with weight. This is an interesting narrative and one we had not seen before the American Families Plan.

One of the issues with the Biden proposal to increase capital gains in its prior form was the lack of substantial revenue assigned to the proposal. In their scoring, the Congressional Budget Office, which provides budget and economic information to Congress, previously hesitated to assign a revenue estimate to capital gains increases because it is an elective tax, and they believed individuals would simply hold on to unrealized gain assets. Linking the elimination of basis step-up at death, the Biden administration now can suggest that an increase in capital gains would result in estimated revenue of $322 billion over ten years. Below the fold, this estimate is really capturing the unrealized gains at an individual's death.

This new idea creates a challenging issue for Republicans in the House and Senate, who are determined to block any tax increases. Simultaneously, the Biden administration will also face an uphill battle convincing more moderate democrats, especially those up for re-election in 2022, that the proposed tax increases are a winning political strategy. Without their support, the chances of passing meaningful tax legislation under the budget reconciliation process may be lost in the choppy sea of negotiation.

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