SUMMARY OF 2021 POTENTIAL TAX LEGISLATION
As of June 30, 2021

I. Biden Administration 2021-22 Budget Proposal ("Green Book")

A. Comments

1. The package is not actual legislation, but it is an official position of how the Administration seeks to fund annual government spending.

2. Historically, most major tax legislation originates as a result of leadership by the Administration to sell it to the public.

3. Oddly, the proposed tax changes are not as wide-ranging as anticipated and do not include tax provisions proposed in Congress. See details below.

B. Specific items included in the Green Book

1. Raise the flat tax rate on C corporation income from 21% to 28%.

a) There is no proposal to eliminate the Section 199A deduction for flowthrough entity business income.

b) Thus, the C corporation rate would increase the top effective rate on individuals with pass-through trade or business income to about the same level (was 29.6%, but this could increase as result of raising the top individual rate, see below).

c) A few centrist Democrats have expressed concern over this large of a rate increase, there is discussion of a compromised rate more toward 25%.

2. Raise the top individual tax bracket from 37% to 39.6% (not including the net investment income tax).

a) The top bracket currently kicks in for single taxpayers at income of $523,600, and $628,300 for married filing joint return. But the proposal would lower the floor of reaching the top bracket to $452,700 for single filing, $509,300 for married filing joint return.

b) If the Section 199A deduction is not eliminated (again, there is no official proposal to do so), the effective rate on high income taxpayers with trade or business income from flowthrough entities would be approximately 31.7%.

3. The taxation of long term capital gains and qualified dividends would be tied to ordinary income rates instead of historical preferential rates.

a) This change would only apply to taxpayers to the extent of adjusted gross income that is in excess of $1 million. Final legislation that bases the change on adjusted gross income vs. taxable income is important. As proposed, large charitable contributions would not help to get below the $1 million threshold.

b) Most notably, it is proposed that this change is retroactive to April 2021.

c) Thus, depending on drafting of the legislation, it could be that gifts and bequests of appreciated property (next item) that have already occurred in 2021 would be subject to this change.

4. Transfers of assets with unrealized appreciation, by lifetime gift or bequest at death, would be treated as a realization event generating capital gains, allowing for a $1 million cumulative exclusion per person, with portability to a surviving spouse.

   a) This means that what is normally a nontaxable transfer, would become a deemed taxable sale.

   b) Oddly, the proposal states that the gain would be "taxable income to the decedent on the Federal gift or estate tax return or on a separate capital gains return". It is not clear if this means that a separate capital gains tax will be applied to this change outside of the normal taxable income of the taxpayer. The tax paid would be a deduction against the decedent's estate.

   c) The proposal also includes a realization event based on the passage of time, where a trust or non-corporate entity holds an asset for a 90-year period. That starting date for testing would be retroactive to January 1, 1940.

   d) No valuation discounts, such as minority interest or lack of marketability, would be allowed for transfers of interests in closely held entities.

   e) Transfers to split interest charitable trusts would be included as to the portion that is the value of the noncharitable interest.

   f) The proposal vaguely states that "the exclusion under current law for capital gain on certain small business stock would also apply", perhaps a reference to the former and now repealed Section 2057 family business entity deduction; perhaps a reference to Section 1202 exclusion for sales of C corporation stock? This could be an interesting planning issue.

   g) This is the tax proposal where the Administration and the bills in Congress have significant overlap. Thus, it should be expected that some version will be included in new tax law that passes this year.

5. Allocations of business income from passthrough entities would be forced to be subject to either self-employment tax or the net investment income tax.

   a) This would eliminate the ability of S corporation shareholders, limited partners and LLC members to not apply either the S/E or NIIT tax on K-1 allocable income.

   b) For S corporation shareholders, the test would be "material participation", with those who participate in a business producing K-1 income subject to self-employment tax.

   c) The statutory exception for limited partners would be removed, so limited partners would pay either S/E tax or NIIT. This change would apply to taxpayers with adjusted gross income above $400,000.

6. Gains allocable to carried interest, which is normally a profits interest issued to professionals who provide services to a hedge fund and private equity fund that issues the profits interest, would be treated as generating ordinary income allocations.

a) This change would be implemented by a recharacterization of gains on sale of portfolio companies or investments in the fund, or sales of the carried interest, from long term capital gains to ordinary income. This change would only apply to taxpayers with taxable income over $400,000 (current Section 1061 with a three year holding period rule would remain in place for lower income taxpayers).

b) This provision could become somewhat irrelevant for very high income taxpayers if the Administration is successful in pushing through the broad increase in long term capital gains rates.

c) Income allocable to carried interest would also be subject to self-employment tax.

7. Section 1031 like kind exchanges for real estate would be eliminated except for exchanges generating gain under $500,000 per year for single taxpayers, and $1 million for married filing jointly. The change would be effective for exchanges completed after 2021, meaning sales of property late in 2021 could trigger the new rule if closing not achieved by December 31.

C. Other comments

1. There are no provisions for changes to the estate, gift and GST tax systems.

2. There are many tax provisions in the Tax Cuts and Jobs Act of 2017 that expire at the end of 2025. The Green Book does not have detailed proposals on how to address most all of those items, so except for some particular items such as the child tax credit, the rules that are set to sunset at that time would do so. Presumably the Biden Administration does not intend to allow expiration of tax rate cuts that were included in TCJA for lower and middle income taxpayers.

3. The tax proposals that are or will be coming out of the Administration are a combination of three dynamics: (1) the need for the President to fulfill campaign promises and funding spending programs, (2) the staffing of the tax policy positions at the Treasury Department (many law professors have been appointed to policy positions), and (3) a desire to erase the tenure of President Trump.

II. Sensible Taxation and Equity Promotion Act ("STEP Act")

A. Similar versions of this legislation package have been introduced in both the House and the Senate, targeting the taxation of unrealized gains upon transfers of property, such as gifts and estates. Some key provisions are summarized below.

1. The proposals are not for a straight, carryover basis regime with elimination of the current basis step up at death. Rather, they approach the taxation of unrealized gains in a similar manner to the Canadian system of triggering deemed taxable transfers at death. But here, it would also apply to lifetime gifts.

2. The gift, or transfer upon death, of appreciated property would be treated as a deemed sale of the property for income tax purposes. Exceptions are included for transfers to spouses, trusts for the benefit of spouses, charitable organizations described in Section 170(c), and any transfers of tangible personal property (except items that are collectibles, held for investment, or used in a trade or business).

3. Transfers to "grantor trusts" would not cause a deemed sale until an event occurs that causes the trust property to be not included in the grantor's estate (e.g. gifts to nongrantor trusts, later recharacterization to nongrantor trust status, or death).

4. Trust distributions of appreciated property from grantor trusts to beneficiaries, other than the grantor, would trigger a deemed sale.

5. For trust property that is continuously held without a sale or distribution, a deemed sale would be imposed everything 30 years. In the House bill, the 30 year period would be retroactive to 30 year periods ending on or after January 1, 2022. In the Senate bill, the period is 21 years, retroactively commencing as of December 31, 2005.

6. A conforming change would eliminate carryover basis on gifted property by adjusting basis to the deemed sale value.

7. The new rules are targeted to high net worth taxpayers by excluding the first $1 million of unrealized appreciation transferred at death, and by not imposing a deemed sale on gifts within the current annual exclusion. In the Senate version, an additional provision would allow the lifetime use of the $1 million exception for unrealized appreciation on covered transfers under $100,000 until the total exemption is exhausted.

8. The Senate bill imposes an annual reporting requirement on trustees of trusts with assets over $1 million or income over $20,000. The trustee would have to furnish to the IRS annually a "full and complete accounting of all trust activities and operations of the year", and names and ID numbers of the trustee, the grantor, and all beneficiaries.

9. A 7 year installment option is allowed for payment of the resulting capital gains tax on illiquid assets (10 years under the Senate version commencing not more than 5 years later).

B. The effective date of the House bill is on transfers after December 31, 2021. **The effective date of the Senate bill is retroactive to transfers after December 31, 2020**.

III. For the 99.5 Percent Act

A. Senators Bernie Sanders and Sheldon Whitehouse have introduced legislation titled the "For the 99.5 Percent Act". It constitutes a thorough attempt to eliminate common estate planning techniques. A summary of key provisions mostly targeting estate and gift tax planning techniques:

1. Lowering of Estate and Gift Exclusion and GST Exemption.

a) The current inflated limitations of $11.7 million for the estate tax exclusion and the GST exemption would be reduced to $3.5 million.

b) The gift tax exclusion would be reduced to $1 million.

c) This would be a return to the laws that were in effect during the 2001 EGTRAA phase-in period when the gift tax exclusion was decoupled from the estate exclusion.

d) The draft of the legislation does not alter the language of Section 2001(g), part of TCJA in 2017, which directed Treasury to issue regulations to address the issue of "clawback" effects upon the lowering of a pre-existing exclusion amount that has been used in a decedent's lifetime gifting. It remains to be seen if a Yellen Treasury would revisit the current regulations that prevent clawback of prior taxable gifts.

e) These changes would be effective for deaths, gifts and GST transfers after December 31, 2021.

2. Estate and Gift Tax Rates.

a) The estate and gift tax rate on cumulative transfers would be increased from the current 40% to 45% for wealth transfer above $3.5 million, 50% for wealth transfers above $10 million, 55% for wealth transfers above $50 million, and 65% for wealth transfers above $1 billion.

b) This change would also be effective starting in 2022.

3. Valuation Discounts.

a) Discounts such as for minority interest holdings and lack of marketability would not be permitted for interests held or transferred in entities controlled or majority-owned by the donor/decedent, transferee, and related family members.

b) This elimination of valuation discounts would be effective for transfers after the date the legislation is enacted.

4. Look-through Rule for Valuation of Nonbusiness Entities.

a) A further valuation change would implement a restriction of valuations of entity ownership interests where the entity holds passive and other nonbusiness assets. The entity ownership would be ignored for valuation purposes, and the estate or gift value would be derived from a look through to the proportionate share of the entity's nonbusiness assets.

b) Further detail is drafted regarding the determination of trade or business vs. other assets, and further look through on tiered entities.

c) This change would be effective for transfers occurring after the date the legislation is enacted.

5. Severe Restrictions to Qualifying GRATs.

a) Current law on GRATs would be revised so that a GRAT would have to have a minimum annuity period of 10 years. A maximum period is also included, being the life expectancy of the donor plus 10 years (apparently targeting the niche planning of 99-year GRATs).

b) Also, the value of the remainder interest upon contribution to the GRAT would have a minimum of the greater of 25% of the present value of the property, or $500,000, but no more than the total value of the property.

c) This eliminates planning with zeroed-out or near zeroed-out GRATs.

d) It becomes difficult to envision when use of a GRAT would make sense given mortality risk (death during the trust term brings the assets back into the taxable estate) and a forced taxable gift within reduced gift tax exclusion levels.

e) This change would be effective when the legislation is enacted.

6. Inclusion of Grantor Trust Assets in Estate.

a) Assets of irrevocable grantor trusts would be included in the grantor's taxable estate.

b) If grantor trust status is relinquished during life, the trust assets would be treated as being transferred in a completed taxable gift (offset by the amount of taxable gifts previously made by the grantor to the trust).

c) Also, distributions from the grantor trust during the grantor's life would be treated as completed gifts.

d) Grantor trust status would extend to a deemed owner of trust assets, when the deemed owner "engages in a sale, exchange, or comparable transaction with the trust that is disregarded" for income tax purposes.

e) This would cause beneficiary defective trusts to be included in the taxable estate of a Section 678 deemed owner. As a result, the common planning technique of nontaxable sales of assets to irrevocable grantor trusts would not be effective.

f) Any estate or gift taxes imposed as a result under this rule would be a liability of the trust, not the grantor, i.e. no tax-free gift imputed by payment of the tax.

g) The grantor trust changes would be effective for trusts created after the date of enactment, for new gifts to grantor trusts after date of enactment, and for new transactions after the date of enactment.

7. Elimination of Dynasty Trusts.

a) GST exempt transfers and distributions from trusts cannot extend more than 50 years from the creation of the trust. After 50 years, the inclusion ratio of the property transferred from the trust is 1. This means in general that these long term indefinite trusts would be forced to be included in taxable estates of beneficiaries.

b) The proposal does not affect the length of dynasty trusts under state trust law (some states allow for trusts that never terminate), but it would truncate the length of GST tax exemption.

c) The inclusion ratio of 1 would take effect upon a GST transfer (taxable distribution, taxable termination or direct skip), so it seems that for GST exempt trusts that accumulate income and principal and do not have a distribution or termination until, for example, 70 years, the GST tax event would be at 70 years, not imposed at the 50 year time limit.

d) These changes would be effective on date of enactment of the legislation. For pre-existing GST exempt trusts, the 50 year period commences on date of enactment.

8. Elimination of Crummey Power Regime.

a) The "present interest" requirement would be removed for annual exclusion gifts, meaning there would be no need to structure gifts to trusts to require a withdrawal power to the beneficiary.

b) However, the price for that change is that there would be a limit of $20,000 (plus inflation, so now $30,000) allowed as annual exclusions for total gifts by a donor in each year that are made to trusts, as outright gifts of passthrough entity interests, and/or made in any other manner that the gifted property cannot be immediately liquidated by the donee. Outright gifts of liquid assets would not be limited by this rule.

c) It appears that, other than outright gifts of cash and marketable securities, and perhaps fee interests in tangible property, only a very limited amount of other gifts of property could be made each year and still qualify for the annual exclusion.

d) This change would be effective for all years beginning after the year the legislation is enacted.

B. The components of the bill are mostly ideas that have been floated in prior legislative proposals or in budget Green Books during the Obama Administration years,

1. So, in general, this looks like familiar territory for Democratic policy makers that have had some support in the past.

2. Since this is likely a revenue raiser in and of itself, it would not be subject to the 10 year budget window in the Senate that causes sunset expirations of tax law changes.

IV. Ultra-Millionaire Tax Act – The Wealth Tax

A. Senator Elizabeth Warren, now a member of the Senate Finance Committee, has introduced legislation to create an annual wealth tax. The legislation largely tracks the wealth tax she had proposed during her presidential campaign in 2020.

B. It is much more of a niche proposal then the Sanders 99.5 Percent Act summarized above. This is new territory and the introduction of a different kind of tax.

C. The bill proposes an annual tax assessment on wealth, not just on unrealized appreciation; a transfer by gift or estate is not needed to trigger the tax.

1. The tax would be 2% on a taxpayer's net wealth that exceeds $50 million. The rate would generally increase to 3% for net wealth above $1 billion.

2. However, that higher tax rate would be adjusted to 6% for the billionaire class if at any time there is signed into law universal health care that prohibits private health insurance.

3. For taxpayers who attempt to weasel out of the obligation by relinquishing citizenship ("covered expatriates"), there would be a 40% tax rate applied to the year of exiting.

4. In the year of death, the wealth tax would be imposed in addition to any estate tax.

D. The bill appropriates $70 billion to Treasury over ten years for enforcement. The bill would require the IRS to annually audit not less than 30% of taxpayers required to pay the wealth tax.

E. There would be an extension of up to five years to pay the tax for taxpayers that demonstrate "severe liquidity constraints" or if there would be undue hardship on an "ongoing enterprise".

F. Penalties would be imposed for a substantial wealth tax valuation understatement if the value claimed on a wealth tax return was less than 65% of final determination, with a penalty of 30%, but then a 50% penalty for gross understatements if the net wealth value claimed on the return was 40% of the correct amount.

G. Individuals and trusts would be subject to the wealth tax. Married persons would be treated as one individual. Trusts that have "substantially the same beneficiaries shall be treated as a single applicable taxpayer". Imagine the regulation-writing project for that item.

H. All "property of the taxpayer", unless specifically excluded, would be included in the calculation of net wealth, and then reduced by debts.

1. Any property includable in the gross estate of the taxpayer under estate tax rules would be included as property of the taxpayer.
2. Assets in grantor trusts would be included as property of the taxpayer.
3. Property transferred to minor children would be included in the transferor's wealth calculation.
4. Assets excluded from determining wealth would be tangible personal property up to a cumulative $50,000 and which is not a collectible.

I. Recognizing the elephant in the room of how to administer the valuation requirements of all property of a taxpayer every year (except $50,000 of tangible personal property), Senator Warren has a plan for that in the bill.

1. Unfortunately, the plan is to tell Treasury to figure it out with regulations.
2. To value illiquid assets, regulations may "utilize retrospective and prospective formulaic valuation methods not currently in use" by the IRS, "may require the use of formulaic valuation approaches for designated assets, including formulaic approaches based on proxies for determining presumptive valuations, formulaic approaches based on prospective adjustments from purchase prices or other prior events", etc., etc. What does all that mean?
3. In other words, don't worry about paying for appraisals, we will tell you what your assets, such as business ownership, are worth under our IRS tables.
4. It demonstrates that this sort of law is being advocated for despite the severe problems in calculating the tax and the high costs of complying with the law.
5. For the moment, the Administration has not indicated any support for this type of tax.

J. A public reaction to the wealth tax might be that a 2% tax rate is not much to ask.

1. For taxpayers now accustomed to income tax rates topping out near 40%, and estate and gift tax rates of a flat 40% above the basic exclusion, a 2% wealth tax seems low.
2. In other words, public opinion might have no problem with this sort of tax that someone else has to pay.

K. Of course, a tax rate on wealth is not equivalent to a tax rate on income and capital gains.

1. If a taxpayer would prefer not to be forced to liquidate invested capital to pay the annual tax, the tax payment would need to come from income and annual return on investment.
2. The current rate on investment income of high bracket taxpayers is a combined 23.8%.
3. Then adding a 2% wealth tax burden on to the same investment assets that are producing, for example, a blended 8% return, would imply a combined tax burden equivalent to a 48.8% income tax on that capital.

V. Other Factors to Consider

A. Outlook on timing:

1. It appears the Democratic leadership wants to have a proposed tax package formulated for public reaction and consensus building by the end of July.
2. Congress has its annual August recess with resumption of duties after Labor Day. Then in the fall, the actual legislation would be drafted, debated, negotiated, and maybe passed.

B. Every Senator has a veto power in a 50/50 Senate.

C. The Blue State members of Congress appear serious enough and capable of holding everything hostage to get a repeal of the $10,000 limit on deducting state and local taxes.

D. Context is needed – the changes summarized above, particularly the estate, gift and wealth tax proposals, are a small part of what is being considered. Much more attention is being given by Congress and the Administration to multinational tax issues and corporate taxation.

E. Estate and gift tax revenue is a very small portion of what Treasury collects each year. The drive to change the rules is more about policy and inequality concerns than about actual tax revenue.

F. Little to no change has been proposed in the following planning areas:

1. Charitable income and estate tax deductions, and tax-exempt status of charitable entities.
2. Life insurance – taxation of inside buildup of policies and exclusion of death benefit.

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