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Tax and Employee Benefits Reform: House Committee on Ways and Means Submits Proposals

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On Sept. 13, 2021, the House Committee on Ways and Means released the remainder of its numerous tax reform proposals. The proposals will be subject to continued negotiations and are **not** law. But, the proposals are an indication of what may be coming soon.

The proposals are far reaching and create or alter individual, corporate, and capital gains tax rates, surtaxes on high earners, restrictions on retirement account contributions and Roth rollovers, lower the estate and gift tax exemption, IRS funding and enforcement, and much more. Notably, the proposal does not include income tax relief from state and local taxes above the $10,000 threshold set in 2017, nor does it repeal or propose new limitations on like-kind exchanges, new minimum taxes on book income for large corporations, or change the current rules allowing for basis step-up at death, all of which were under consideration to be changed.

From here, the proposal will be submitted to the rest of the House for negotiation, and an eventual vote on the House floor. A similar process is occurring in the Senate, with the Senate Finance Committee not having yet submitted its proposals for markups and a vote on the Senate floor. If both the House and Senate vote in favor on their respective bills, the bills are merged before a final draft is sent to the president for his approval.

A summary of the proposal’s key changes follows.

Corporate and Business

- ***Increase in Corporate Tax Rate.*** The provision would replace the flat corporate income tax with a graduated rate structure. The rate structure provides for a rate of 18% on the first $400,000 of income; 21% on income up to $5 million, and a rate of 26.5% on income thereafter. The benefit of the graduated rate phases out for corporations making more than $10 million. Personal services corporations are not eligible for graduated rates. The domestic dividends received deduction is adjusted to hold constant the tax on domestic corporate-to-

corporate dividends.

- ***Modifications to Treatment of Certain Losses Related to Securities, Partnership Interests, and Corporate Subsidiaries***. The provision would amend Section 165(g) to provide that losses with respect to securities are treated as realized on the day that the event establishing worthlessness occurs. In addition, the provision provides that partnership indebtedness is treated in the same manner as corporate indebtedness. Furthermore, the rule amends section 165 to provide that a loss on a worthless partnership interest is subject to the same rules as a loss in a sale of a partnership interest. This provision is applicable for taxable years beginning after Dec. 31, 2021. The rule also changes the treatment of taxable liquidations of corporate subsidiaries. Under the provision, a loss in a taxable liquidation is deferred until the property received in the liquidation is sold to a third party. This provision is applicable to liquidations after the date of enactment.

- ***Modification of Rules for Partnership Interests Held in Connection with Performance of Services.*** The provision would make several changes to Section 1061. First, the provision generally extends the holding period required for gains attributable to an applicable partnership interest to qualify for long-term capital gain treatment from three to five years. The provision retains the three-year holding period for real property trades or businesses and taxpayers with an Adjusted Gross Income ("AGI") of less than $400,000. The provision also extends Section 1061 to all assets eligible for long-term capital gain rates. In addition, the provision adds rules for a measuring the three- or five-year holding period, including in the context of tiered partnerships, and modifies the rules applicable to sale or exchange transactions, and extends regulatory authority under the provision to address carry waivers and arrangements that avoid the purposes of this section. The provision applies to taxable years beginning after Dec. 31, 2021.

- ***Limitation on Certain Special Rules for Capital Gains on Sale of Select Small Businesses.*** The provision would amend Section 1202(a) to provide that the special 75% and 100% exclusion rates for gains realized from certain qualified small business stock will not apply to taxpayers with adjusted gross income equal or exceeding $400,000. The baseline 50% exclusion in 1202(a)(1) remains available for all taxpayers. The amendments made by this section apply to sales and exchanges after Sept. 13, 2021, subject to a binding contract exception.

- ***Wash Sales.*** This provision includes commodities, currencies, and digital assets in the wash sale rule, an anti-abuse rule previously applicable to stocks and other securities. The wash sale rule in section 1091 prevents taxpayers from claiming tax losses while retaining an interest in the loss asset. The proposed amendments apply to taxable years beginning after Dec. 31, 2021.

- ***Modification of Procedural Requirements Relating to Assessment of Penalties***. This provision would move up the effective date of the amendment to Section 162(m) in the American Rescue Plan Act of 2021 ("ARPA") to tax years following Dec. 31, 2021. ARPA expanded the set of applicable employees under Section 162(m) to include the eight most highly compensated officers other than the principal executive and principal financial officers for a taxable year, beginning in tax years after Dec. 31, 2026. The additional five employees under the ARPA amendment are not considered permanent covered employees for the purposes of the section. The provision also applies the Section 414 aggregation rules for covered health insurance providers to the general rule under Section 162(m), expands the

IRS' regulatory authority under the general rule, and expands the definition of applicable employee remuneration.

- ***Temporary Rule to Allow Certain S Corporations to Reorganize as Partnerships Without Tax.*** This provision would allow eligible S corporations to reorganize as partnerships without such reorganizations triggering tax. Eligible S corporation means any corporation that was an S corporation on May 13, 1996 (prior to the publication of the current "check the box" regulations with respect to entity classification). The eligible S corporation would have to completely liquidate and transfer substantially all of its assets and liabilities to a domestic partnership during the two-year period beginning on Dec. 31, 2021.

Tax Increases for High-Earning Individuals

- ***Increase in Top Marginal Income Tax Rate.*** This provision would increase the top marginal individual income tax rate in Section 1(j)(2) to 39.6%. This marginal rate applies to married individuals filing jointly with taxable income over $450,000, to heads of households with taxable income over $425,000, to unmarried individuals with taxable income over $400,000, to married individuals filing separate returns with taxable income over $225,000, and to estates and trusts with taxable income over $12,500. The amendments proposed by this section would apply to taxable years beginning after Dec. 31, 2021.

- ***Increase in Capital Gains Rate for Certain High-Income Individuals.*** This provision increases the capital gains rate in Section 1(h)(1)(D) to 25%. The amendments proposed by this section apply to taxable years ending after the date of introduction of the Act, if signed into law. A transition rule provides that the preexisting statutory rate of 20% continues to apply to gains and losses for the portion of the taxable year prior to the date of introduction. Gains recognized later in the same taxable year that arise from transactions entered into before the date of introduction pursuant to a written binding contract are treated as occurring prior to the date of introduction.

- ***Application of Net Investment Income Tax to Trade or Business Income of Certain High-Income Individuals***. This provision would amend Section 1411 to expand the net investment income tax to cover net investment income derived in the ordinary course of a trade or business for taxpayers with greater than $400,000 in taxable income (single filer) or $500,000 (joint filer), as well as for trusts and estates. The provision clarifies that this tax is not assessed on wages on which FICA is already imposed. The amendments made by this section apply to taxable years beginning after Dec. 31, 2021.

- ***Limitation on Deduction of Qualified Business Income for Certain High-Income Individuals.*** This provision would amend Section 199A by setting the maximum allowable deduction at $500,000 in the case of a joint return, $400,000 for an individual return, $250,000 for a married individual filing a separate return, and $10,000 for a trust or estate. The amendments proposed by this section would apply to taxable years beginning after Dec. 31, 2021.

- ***Limitations on Excess Business Losses of Non-Corporate Taxpayers***. This provision would amend Section 461(l) to permanently disallow excess business losses (i.e., net business deductions in excess of business income) for non-corporate taxpayers. The

provision would allow taxpayers whose losses are disallowed to carry those losses forward to the next succeeding taxable year. The amendments proposed by this section would apply to taxable years beginning after Dec. 31, 2021.

- ***Surcharge on High-Income Individuals, Trusts, and Estates**.* This provision would add Section 1A, which imposes a tax equal to 3% of a taxpayer's modified adjusted gross income in excess of $5 million (or in excess of $2.5 million for a married individual filing separately). For this purpose, modified adjusted gross income means adjusted gross income reduced by any deduction allowed for investment interest (as defined in Section 163(d)). The amendments proposed by this section would apply to taxable years beginning after Dec. 31, 2021.

- ***Termination of Temporary Increase in Unified Credit.*** This provision would terminate the temporary increase in the unified credit against estate and gift taxes, reverting the credit to its 2010 level of $5 million per individual, indexed for inflation.

- ***Increase in Limitation of Estate Tax Valuation Reduction for Certain Real Property Used in Farming or Other Trades or Businesses**.* This provision would amend Section 2032A to increase the special valuation reduction available for qualified real property used in a family farm or family business. This reduction allows decedents who own real property used in a farm or business to value the property for estate-tax purposes based on its actual use rather than fair-market value. This provision would increase the allowable reduction from $750,000 to $11.7 million.

- ***Certain Tax Rules Applicable to Grantor Trusts**.* This provision would add Section 2901, which pulls grantor trusts into a decedent's taxable estate when the decedent is the deemed owner of the trusts. Currently, taxpayers are able to use grantor trusts to push assets out of their estate while controlling the trust closely. The provision would also add a new Section 1062, which treats sales between grantor trusts and their deemed owner as equivalent to sales between the owner and a third party. The amendments proposed by this section would apply only to future trusts and future transfers.

- ***Valuation Rules for Certain Transfers of Nonbusiness Assets**.* This provision would amend Section 2031 by clarifying that when a taxpayer transfers nonbusiness assets, those assets should not be afforded a valuation discount for transfer tax purposes. Nonbusiness assets are passive assets that are held for the production of income and not used in the active conduct of a trade or business. Exceptions are provided for assets used in hedging transactions or as working capital of a business. A look-through rule provides that when a passive asset consists of a 10% interest in some other entity, the rule is applied by treating the holder as holding its ratable share of the assets of that other entity directly. The amendments proposed by this proposal would apply to transfers after the date of the enactment of the Act, if signed into law.

Modifications to Rules for Retirement Plan Accounts

- ***Contribution Limit for Individual Retirement Plans of High-Income Taxpayers with Large Account Balances.*** Under current law, taxpayers may make contributions to IRAs irrespective of how much they already have saved in such accounts. To avoid subsidizing retirement savings once account balances reach very high levels, the legislation creates new

rules for taxpayers with very large IRA and defined contribution retirement account balances. Specifically, the legislation prohibits further contributions to a Roth or traditional IRA for a taxable year if the total value of an individual's IRA and defined contribution retirement accounts generally exceeds $10 million as of the end of the prior taxable year. The limit on contributions would only apply to single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of households with taxable income over $425,000 (all indexed for inflation). The proposed legislation also adds a new annual reporting requirement for employer-defined contribution plans on aggregate account balances in excess of $2.5 million. The reporting would be to both the Internal Revenue Service and the plan participant whose balance is being reported. These proposed provisions would be effective for tax years beginning after Dec. 31, 2021.

- ***Increase in Minimum Required Distributions for High-Income Taxpayers with Large Retirement Account Balances****.* If an individual's combined traditional IRA, Roth IRA and defined contribution retirement account balances generally exceed $10 million 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 is above the thresholds described in the section 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 million limit. In addition, to the extent that the combined balance amount in traditional IRAs, Roth IRAs and defined contribution plans exceeds $20 million, that excess is required to be distributed from Roth IRAs and Roth-designated accounts in defined contribution plans up to the lesser of (1) the amount needed to bring the total balance in all accounts down to $20 million or (2) the aggregate balance in the Roth IRAs and designated Roth accounts in defined contribution plans. Once the individual distributes the amount of any excess required under this 100% distribution rule, then the individual is allowed to determine the accounts from which to distribute to satisfy the 50% distribution rule above. This proposed provision would be effective in tax years beginning after Dec. 31, 2021.

- ***Treatment of Rollovers and Conversions to Roth IRAs****.* Under current law, contributions to Roth IRAs have income limitations. For example, the income range for single taxpayers for making contributions to Roth IRAs for 2021 is $125,000 to $140,000. Those single taxpayers with income above $140,000 generally are not permitted to make Roth IRA contributions. However, in 2010, the similar income limitations for Roth IRA conversions were repealed, which allowed anyone to contribute to a Roth IRA through a conversion, irrespective of the still-in-force income limitations for Roth IRA contributions. As an example, if a person exceeds the income limitation for contributions to a Roth IRA, such person can make a nondeductible contribution to a traditional IRA – and then shortly thereafter convert the nondeductible contribution from the traditional IRA to a Roth IRA. In order to close these so-called "backdoor" Roth IRA strategies, this provision eliminates Roth conversions for both IRAs and employer-sponsored plans for single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation). This provision would apply to distributions, transfers, and contributions made in taxable years beginning after Dec. 31, 2031. Furthermore, this section would prohibit all employee after-tax contributions in qualified plans and prohibits after-tax IRA contributions from being converted to Roth regardless of income level, effective for distributions, transfers, and contributions made after Dec. 31, 2021.

- ***Prohibition of IRA Investments Conditioned on Account Holder's Status.*** This provision would prohibit an IRA from holding any security if the issuer of the security requires the IRA owner to have a certain minimum level of assets or income, or have completed a minimum level of education or obtained a specific license or credential. For example, the legislation prohibits IRAs from holding investments which are offered to accredited investors because those investments are securities that have not been registered under federal securities laws. IRAs holding such investments would lose their IRA status. This proposal would generally take effect for tax years beginning after Dec. 31, 2021, but there is a two-year transition period for IRAs already holding these investments.

- ***Prohibition of Investment of IRA Assets in Entities in Which the Owner Has a Substantial Interest.*** To prevent self-dealing, under current law prohibited transaction rules, an IRA owner cannot invest IRA assets in a corporation, partnership, trust, or estate in which he or she has a 50% or greater interest. However, an IRA owner can invest IRA assets in a business in which they own, for example, one-third of the business while also acting as the CEO. The bill adjusts the 50% threshold to 10% for investments that are not tradable on an established securities market, regardless of whether the IRA owner has a direct or indirect interest. The bill also prevents investing in an entity in which the IRA owner is an officer. Further, the bill would modify the rule to be an IRA requirement, rather than a prohibited transaction rule (i.e., in order to be an IRA, it would have to meet this requirement). This proposal would generally take effect for tax years beginning after Dec. 31, 2021, but there is a two-year transition period for IRAs already holding these investments.

IRS Funding and Taxpayer Compliance

- ***Funding of the Internal Revenue Service.*** This provision appropriates $78.935 million for necessary expenses for the IRS for strengthening tax-enforcement activities and increasing voluntary compliance, and modernizing information technology to effectively support enforcement activities. No use of these funds is intended to increase taxes on any taxpayer with taxable income below $400,000. Further, $410 million is appropriated for necessary expenses for the Treasury Inspector General for Tax Administration to provide oversight of the IRS. Finally, $157 million is appropriated for the tax court for adjudicating tax disputes. These appropriated funds are to remain available until Sept. 30, 2031.

- ***Limitation on Deduction for Qualified Conservation Contributions Made by Pass-Through Entities.*** Intended to curb syndicated conservation easement tax shelters, this provision would deny charitable deduction for contributions of conservation easements by partnerships and other pass-through entities if the amount of the contribution (and therefore the deduction) exceeds 2.5 times the sum of each partner's adjusted basis in the partnership that relates to the donated property. This general disallowance rule would not apply to donations of property that meet the requirements of the three-year holding-period rule, and contributions by family partnerships. In addition, certain taxpayers whose deeds are found to have certain defects and are notified by the tax commissioner would have the opportunity to correct such defects within 90 days of the notice. This ability to cure would not apply in the case of reportable transactions and transactions for which deduction is disallowed under this section. Various accuracy-related penalties apply, including gross-valuation-misstatement penalty, and adjustments are made to the statute of limitations on assessment and collection by the IRS in the case of any disallowance of a deduction by reason of this provision. This proposal provision would apply to contributions made after Dec. 23, 2016 (the date of the

relevant IRS Notice). In the case of contributions of easements related to the preservation of certified historic structures, this provision would apply to contributions made in taxable years beginning after Dec. 31, 2018. The ability to cure defective deeds would be permitted for returns filed after the date of the enactment and for returns filed on or before such date if the Section 6501 period has not expired as of such date.

This is a non-exhaustive list of the House Committee on Ways and Means proposals on taxation reform.

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