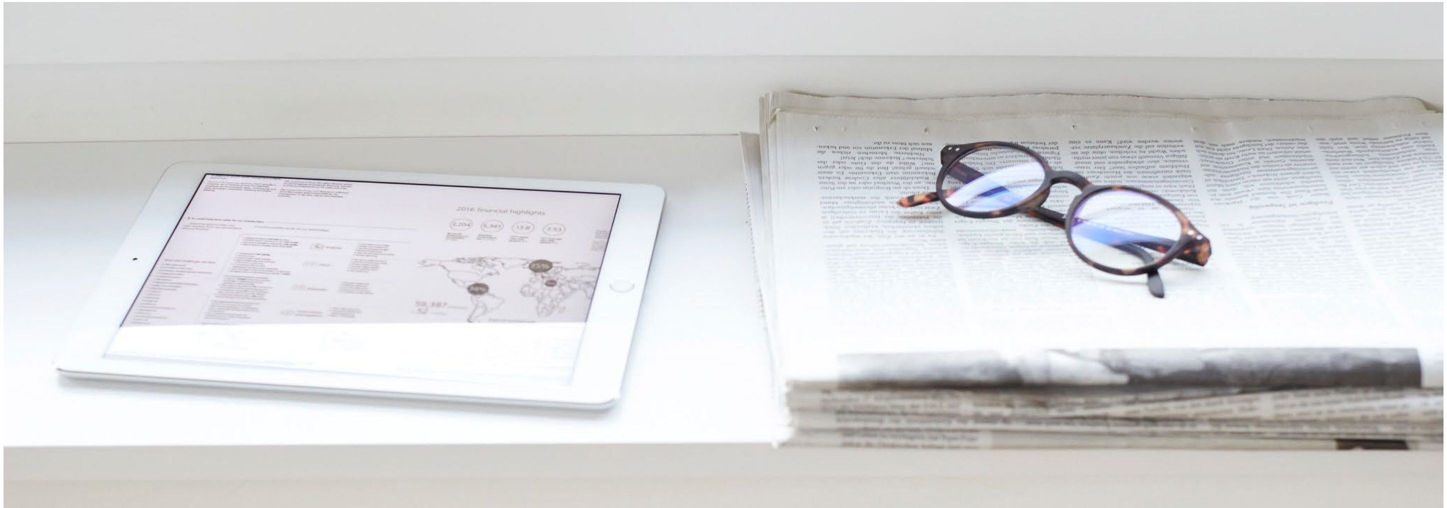

Advanced Planning Alert

House Democrats move one step closer to tax increases, offering details and dates

By Brad Dillon and Benjamin Trayes
September 14, 2021

On September 13, 2021, the House Ways and Means Committee released the proposed tax provisions of the broader budget reconciliation bill that Democrats hope to pass in the upcoming weeks. The draft bill, which has been largely pre-cleared with the House Democrats, is a next step—not a final step—in the legislative process. Soon, the Senate Democrats will produce their own separate draft bill that will undoubtedly have material differences with the House's version, all of which must be reconciled before a final bill lands on the president's desk for signature. Although many of the provisions in the House's draft bill are likely to make it into the final bill, some proposals are bound to be scrapped or significantly modified. This is to say that the final details will remain fluid over the coming weeks as negotiations continue.

While there are certainly some surprises buried in the 881-page draft bill, the overall trajectory of the potential legislation is clear: if enacted, taxes are going up in a myriad of ways for corporations and wealthier taxpayers. The details of the House's draft bill, as they relate to several of the domestic tax proposals, are below, and a few frequently asked questions and answers follow.

TOP INDIVIDUAL INCOME TAX RATE INCREASE

The Tax Cuts and Jobs Act of 2017 (TCJA) decreased the top marginal individual income tax rate from 39.6% to 37%. Under the House's draft bill, the rate reverts to 39.6%. In addition, the proposal expands the pool of the top brackets by applying it to (i) married individuals filing jointly with taxable income over $450,000, (ii) heads of households with taxable income over $425,000, (iii) unmarried individuals with taxable income over $400,000, (iv) married individuals filing separate returns with taxable income over $225,000, and (v) estates and trusts with taxable income over $12,500. The provision applies to taxable years beginning after December 31, 2021.

TOP CAPITAL GAINS TAX RATE INCREASE

The House's draft bill increases the top capital gains tax rate to 25%. (In many cases, the net investment income tax, which this bill would expand, effectively pushes the top rate on capital gains to 28.8%.) The proposal makes the 25% rate effective beginning after September 13, 2021, unless a written binding contract had been entered into on or before September 13, 2021, with respect to such property.

TAX SURCHARGE

In addition to increased income and capital gain tax rates beginning after December 31, 2021, high income individuals, trusts, and estates would be subject to an additional 3% tax on certain income. The tax applies to modified adjusted gross income in excess of $100,000 for any trust or estate, $2.5 million for a married individual filing separately, and $5 million for any other taxpayer. Modified adjusted gross income is a taxpayer's income less certain adjustments, such as for contributions to retirement accounts and deductions for certain investment expenses.

ESTATE PLANNING PROPOSALS

The House's draft bill includes various provisions that will affect gift and estate tax planning, as well as legacy planning.

Estate and gift tax exemption amount

The TCJA doubled the gift and estate tax exemption for estates of decedents dying or gifts made between January 1, 2018, and December 31, 2025. In 2021, the exemption amount is $11.7 million. The House's draft bill proposes an early termination to that doubled amount beginning for tax years after December 31, 2021, which would reduce the exemption amount to the 2010 level of $5 million, plus inflation.

Grantor trust rule changes

When a trust qualifies as a grantor trust for income tax purposes due to certain powers the grantor has retained under the trust, the grantor is treated for federal income tax purposes as the owner of the trust's assets. The benefit of this treatment is that the trust assets can grow without paying income tax out of the trust's assets, and the grantor can essentially make an additional transfer to the trust by paying the tax. In addition, because the grantor and trust are treated as one for income tax purposes, the grantor can sell assets to the trust with no federal income tax consequences.

The House's draft bill makes several changes to grantor trust rules. First, the assets of a grantor trust will generally be included in the estate of the grantor upon the grantor's death. Second, if grantor trust status is terminated prior to the death of the grantor or a distribution is made from the trust, the value of the trust or the amount of the distribution will generally be treated as a gift.

Third, the House's draft bill provides that for purposes of any transfer or sale between a grantor and a grantor trust, grantor status will be disregarded, which will allow sales between a grantor and a grantor trust to be taxed.

The changes to the grantor trust rules will apply to trusts created on or after the date of the enactment of the bill and will apply to any contribution to an existing trust on or after that date.

Valuation of nonbusiness assets

The House's draft bill also targets the valuation of certain nonbusiness assets for estate and gift tax purposes. The measure provides that no valuation discount, including for lack of marketability or lack of control, is permitted for nonbusiness assets. 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. There are exceptions for assets used as the working capital of a business or in hedging transactions and for real property used in certain businesses.

RETIREMENT PLANS

Following reports of large balances in tax-favored retirement accounts, the House's draft bill includes several provisions targeting wealthy taxpayers and other provisions relating to such accounts.

Contribution limits

Under current law, a taxpayer may contribute to an individual retirement account (IRA) regardless of how much the taxpayer's IRAs hold. Under the House's draft bill, a taxpayer may not make further contributions to an IRA if the aggregate value of certain retirement accounts exceeds $10 million at the end of the prior tax year. The limit applies to single taxpayers (or taxpayers married filing separately) with taxable income greater than $400,000, married taxpayers filing jointly with taxable income greater than $450,000, and heads of households with taxable income greater than $425,000. (These income thresholds also apply to the required distributions discussed below.) The provision takes effect for tax years after December 31, 2021.

Required distributions

The House's draft bill targets large retirement accounts by creating new required minimum distributions for taxpayers who exceed the income thresholds, regardless of the taxpayer's age. If a taxpayer's retirement accounts exceed $10 million in the aggregate at the end of the preceding taxable year, an amount generally equal to 50% of the excess must be distributed to the taxpayer. If the accounts exceed $20 million, (i) the excess must be distributed from a Roth account up to the lesser of (a) the amount of such excess and (b) the balance of the Roth accounts and (ii) then any account may be used for the 50% distribution. The distributions are not eligible for rollovers to another retirement account. The provision takes effect for tax years after December 31, 2021.

Closing the backdoor Roth conversion

Unlike traditional IRAs, Roth IRAs have contribution income limitations. If a taxpayer's income exceeds the limit, the taxpayer may not make a direct contribution to a Roth. However, under current law, conversions from a traditional IRA to a Roth IRA do not have income limitations, which permitted so-called "backdoor" conversions. The House's draft bill eliminates Roth conversions for taxpayers who exceed the income thresholds. Notably, the bill provides that this new rule applies to conversions after December 31, 2031.[1]

This bill also prohibits all employee after-tax contributions in qualified plans and prohibits after-tax IRA contributions from being converted to Roth IRAs regardless of income level. This prohibition is effective for distributions, transfers, and contributions made after December 31, 2021.

Owner status investments

Under federal tax law, IRAs receive special treatment that defers tax until distributions are made. The House's draft bill threatens that treatment if an IRA holds any security that requires the IRA owner to represent that the individual has a certain amount of assets or income, reached a certain level of education, or attained a certain license or credential. Subject to a two-year transition period for IRAs that hold such securities on the date the measure is enacted, the provision takes effect for tax years beginning after December 31, 2021.

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[1] No, that's not a typo. That's what's in the House draft bill. Based on what our colleagues in the UBS Office of Public Policy have heard, the draft bill is correct, and lawmakers do, in fact, intend to make that provision effective to conversions after December 31, 2031.

Substantial interest investments

Similarly, an IRA may lose its exempt status under federal tax law if it invests in a privately held corporation, partnership, trust, or estate in which the account owner owns at least 10% of such entity or serves as an officer of such entity.

QUALIFIED SMALL BUSINESS STOCK

Under Section 1202 of the Internal Revenue Code, a portion (or all) of the capital gain from the sale of certain qualified small business stock may be excluded from federal tax. The House's draft bill reduces special 75% and 100% exclusion rates for taxpayers with adjusted gross income equal to or exceeding $400,000, limiting them to 50%. The measure applies to sales and exchanges on or after September 13, 2021, subject to an exception to the lower threshold for a written binding contract in effect on September 12, 2021.

QUALIFIED BUSINESS INCOME DEDUCTION LIMITS

The TCJA created Section 199A of the Internal Revenue Code, which permits owners of sole proprietorships, S corporations, partnerships, and some trusts and estate to deduct up to 20% of income from a qualified trade or business. Under the House's draft bill, Section 199A is amended to cap the maximum deduction at $500,000 for 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 measure applies to taxable years beginning after December 31, 2021.

CORPORATE TAX RATES

The House's draft bill replaces the flat corporate income tax rate with a graduated rate structure, which includes a rate cut to 18% on the first $400,000 of income. For amounts in excess of $400,000 and up to $5 million, the 21% rate remains, and amounts in excess of $5 million will be taxed at 26.5%. A corporation with income greater than $10 million will have additional tax equal to the lesser of (i) 3% of such excess and (ii) $287,000. Qualified personal service corporations (as defined by the IRS) are not eligible for graduated rates and will be taxed at the highest 26.5% rate. The new rates would apply to income earned after December 31, 2021.

WASH SALES EXPANSION

The IRS has long prohibited owners of stock and other securities from selling the stock at a loss, repurchasing the stock within 30 days and claiming the loss. To close a potential loophole, the House bill includes commodities, currencies, and digital assets in the wash sale rules (but with an expanded period during which the purchase would trigger the denial of the loss). The provision applies to sales and other dispositions beginning after December 31, 2021.

CURBS ON CONSERVATION EASEMENT DEDUCTIONS

In Notice 2017-10, the IRS made certain pre-packaged conservation easements listed transactions, which requires notice to the IRS of any such transaction. To curb the use of these vehicles, the House bill denies a charitable deduction for contributions by partnerships (and other pass-through entities) if the deduction would exceed 2.5 times the sum of each partner's adjusted basis in the partnership that is allocable to the donated property. However, a deduction will be permitted if (i) three-year holding periods are met for the property and partners and (ii) the contribution is from a partnership held by family members. Generally, the provisions apply to contributions made after December 23, 2016, based on IRS Notice 2017-10.

CARRIED INTEREST

The House's draft bill weakens the preferential tax treatment for carried interest at the favorable long-term capital gains rate but does not eliminate it. The bill increases the period that an asset must be held for favorable capital gains treatment from three years under current law to five years.

FREQUENTLY ASKED QUESTIONS

Q: Q: Is it too late to harvest capital gains at the lower 20% rate?

A: It depends. The House's draft bill makes the higher 25% rate effective after September 13, 2021, but there are two important caveats to be aware of with regard to this effective date. First, as noted above, the House's draft bill includes a transitional rule for assets being sold that had already entered into binding contracts on or before September 13, 2021. Gains recognized later in 2021 that arise from transactions entered into on or before that date and pursuant to a written binding contract are treated as occurring prior to that date, meaning that such gains would be subject to the lower 20% rate (exclusive of the net investment income tax). Second, while there is a possibility that the Senate version of the bill could include a later effective date, a fair assumption is that if capital gain rates do increase, September 13, 2021, will be the cut-off date for the higher rate.

Q: Should I continue to engage in estate planning?

A: Yes. While the House's draft bill proposes very serious changes to the estate planning landscape, it left the lifetime exemption untouched through the remainder of 2021, after which point the exemption would be cut approximately in half from its all-time historic high of $11.7 million per individual ($23.4 million for a married couple) to roughly $5.5 million per individual ($11 million for a married couple). Utilizing one's exemption to make significant gifts during one's lifetime is still the most effective way to reduce one's impending estate tax liability at death, and there is a potentially fleeting opportunity to shift more wealth (and all of its subsequent appreciation) outside of one's taxable estate now, while the exemption is high, than there may be just a few months from now when it may be significantly lower.

Q: If I've used up all of my lifetime exemption already, do the estate planning changes in the draft bill affect me?

A: If the goal is to continue to reduce one's estate tax liability at death, then yes, some of the proposed changes, if enacted, would likely curtail many planning strategies used to reduce estate taxes for those who have used up their available exemptions. For example, two strategies whose fate might be in jeopardy are grantor-retained annuity trusts (GRATs) and sales to intentionally defective grantor trusts. Both of these strategies essentially freeze the value of one's estate by shifting the appreciation of assets (above a certain rate) out of the estate with little or no gift tax cost. The draft bill takes specific aim at so-called grantor trusts and effectively guts the benefits of their uses, including with these two strategies. There will undoubtedly still be ways to utilize these strategies even if the proposed rules are enacted, though, at this juncture, it appears that the results will be much less tax efficient than would be achieved under the current rules. Because these changes appear to be made effective as of the date of the final bill's enactment, there may only be a very short window in which to complete more tax efficient planning with grantor trusts, including GRATs and sales to defective grantor trusts.

Q: What was left out of the House's draft bill that might reappear in a final bill?

A: Many of the proposals that the Biden administration outlined in detail in the Spring were omitted from the House's draft bill, though any of these omitted proposals could resurface in later drafts and ultimately make it into a final bill. It is still too early to tell just yet which tax changes will make it into a final bill, however. First, the Biden administration had proposed treating death as an income tax realization event for decedents, but the House Democrats excluded this change from its draft legislation, leaving in place the current step-up in basis rules. While certain Senators are interested in the elimination of step-up basis, it is unlikely that the Senate's version of the bill will include a change here, but it is still too early to make that call. Second, the Biden administration had proposed significantly curtailing the ability to defer the gain from certain like-kind exchanges, also known as 1031 exchanges. Here again, it is unlikely to be resurrected in a later version of the bill. Finally, though not part of the administration's proposal, an expected change that was omitted from the House draft was relief from the limitation on the deductibility of state and local income taxes (SALT). The UBS Office of Public Policy expects, however, that there will be some reprieve from the SALT limitation that makes it into a later version of the legislation; indeed, a bill might not pass at all if no reprieve is written into the bill.

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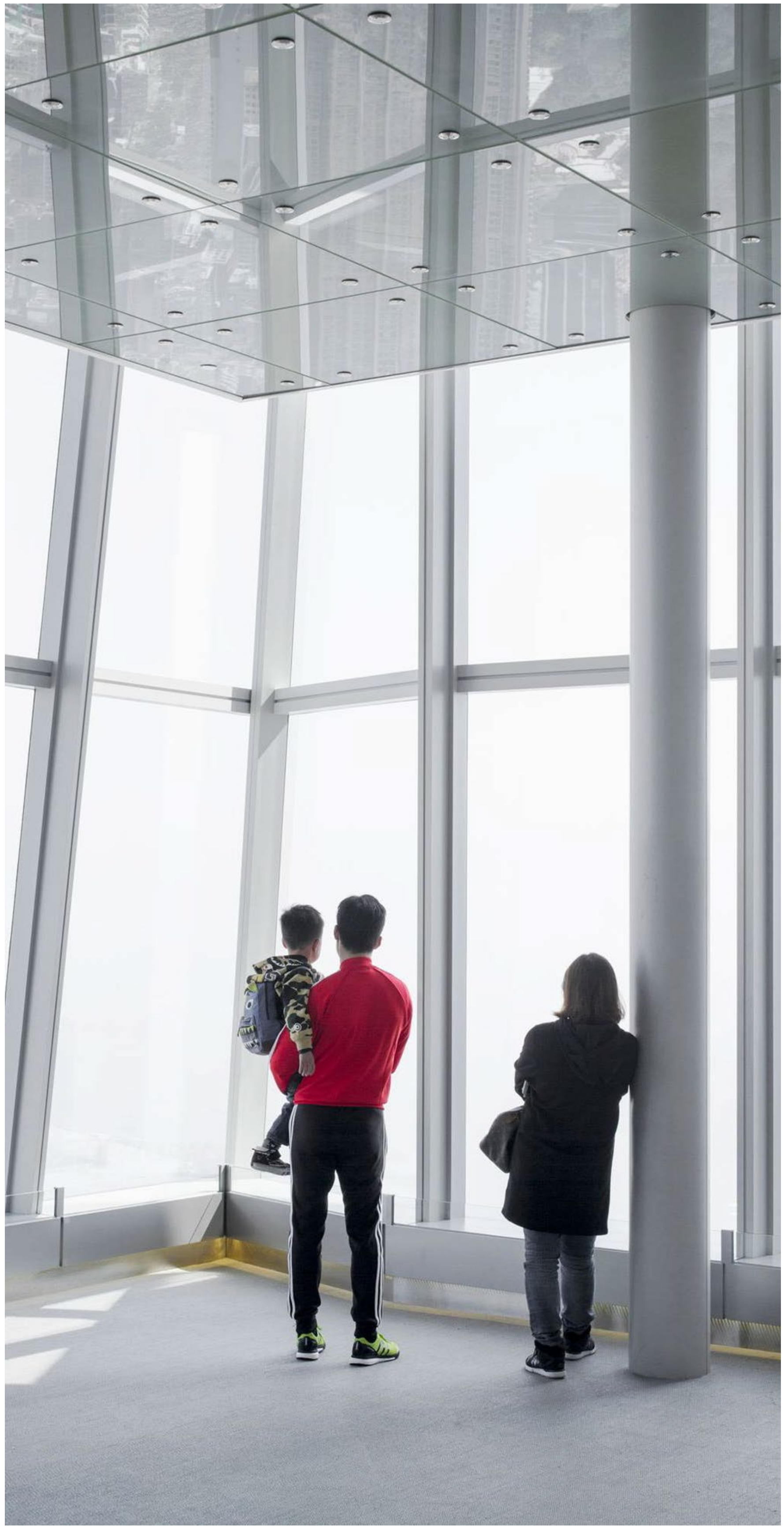

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Original Publication Date: September 2021

Approval Code: IS2104969
Expiration Date: September 30, 2022