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House Democrats Propose Sweeping New Changes To Tax Laws That Stand To Have Major Impact On Business Taxation and Estate Planning—Part 1

On September 13, 2021, Democrats in the House of Representatives released a new $3.5 trillion proposed spending plan that includes a wide array of changes to federal tax laws. Specifically, the Democrats have proposed a number of significant tax increases and other changes to fund the plan, including increases to personal income tax rates and the capital gains tax rate, along with a major reduction to the federal estate and gift tax exclusion and new restrictions on qualified business income (QBI) deductions.

While the proposed legislation is still under consideration and far from being finalized, given the broad-reaching impact these changes stand to have, we strongly encourage you to take action now if you would be affected by the proposed legislation if it does pass. With the exception of the capital gains rate increase, which could go into effect on transactions that occur on or after Sept. 13, 2021, most of the proposed changes would be effective after December 31, 2021, meaning that you have time to plan now.

That said, due to the time it takes to plan and execute some of the financial and estate planning actions we'd need to support you with, we suggest you start strategizing now. That way, you'll have plenty of time to take the appropriate action before the end of the year. With that in mind, here we'll outline the ways the proposed tax law changes stand to affect your business as well as your personal financial, tax, and estate planning, so you can contact us if you would be impacted if the bill does pass.

1. Increase in Individual Income Tax Rates

Proposed changes: Under the proposed legislation, the top personal income tax rate would increase from 37% to 39.6% for married individuals filing jointly with taxable income over $450,000; single taxpayers with taxable income over $400,000; and married individuals filing separate returns with income over $225,000. Additionally, this increase would also apply to trusts and estates with taxable income over $12,500.

The bill would also create a new 3% surcharge on individuals with modified adjusted gross income (AGI) exceeding $5 million (or $2.5 million for married individuals filing separately) as well as on trusts with AGI greater than $100,000.

Additionally, the net investment income tax (NIIT) would be extended to cover net investment income derived in the ordinary course of a trade or business for individuals with taxable income of greater than $400,000 for individuals or $500,000 for those filing jointly, as well as for trusts and estates. The NIIT tax does not apply to earnings already subject to FICA tax.

These proposed changes are set to be effective for tax years beginning after December 31, 2021.

Potential planning solutions: Since these increases will apply to taxable years beginning after December 31, 2021, we suggest you earn as much as you can this year and consider pushing deductions into next year, while you can still take advantage of historically low tax rates. Keep in mind that if you have a high income and decide to put off planning, you may pay much more in income taxes because of the 3% surcharge on high income and the 3.8% NIIT that will now apply to active business income for high incomes.

Moreover, the increase in personal income tax rates, along with the new 3% surcharge and changes to the NIIT have critical importance to estate planning, since the highest rate applies to estates and trusts with taxable income over $12,500, which is a drastically lower income level at which the highest tax rates apply to individuals, such as beneficiaries of a trust. Given these changes, it may be worth accelerating income for estate and trusts in 2021, while rates are lower.

For so-called “complex” or “non-grantor trusts” that pay their own income tax, distributions may carry out income to the beneficiary in order to be taxed at a lower rate. That said, the benefits of a possibly lower tax rate should be weighed against the impact of an outright distribution of funds to a beneficiary and the inclusion of those funds in the beneficiary’s estate if the distributed funds are not spent. For example, would an outright distribution negatively impact a beneficiary with poor money-management skills or issues with substance abuse?

If you will earn more than these income limits this year, meet with your Family Business

Lawyer® as soon as possible to discuss a plan to adapt your financial and estate planning to offset the impact of these changes.

2. Increase In Corporate Tax Rates

Proposed changes: The new bill would revert the current flat corporate tax rate of 21% to the pre-2017 system of graduated corporate taxes as follows: The bill increases the top corporate tax rate from 21% to 26.5% for C Corporations earning in excess of $5 million, but it would reduce the lowest rate to 18% for C Corporations with income less than $400,000. For Corporations earning between $400,000 and $5 million, the rate remains unchanged at 21%.

One notable exception—under the bill, corporations that are taxed as personal service corporations are not eligible for the graduated rates and instead are subject to a flat rate of 26.5%. Additionally, the bill would increase the minimum tax rate on overseas corporate income from 10.5% to roughly 16.5%. It also reduces the percentage of foreign income that can be excluded from the minimum tax to 5% from 10%.

These tax changes are proposed to be effective for taxable years beginning after December 31, 2021.

Potential planning solutions: If you have a C Corporation, contact us now to coordinate your planning with your CPA before the end of 2021.

3. Restrictions On Section 199A Qualified Business Income Deduction

Proposed changes: The bill would add a cap to the 20% deduction for qualified business income (QBI) under Section 199A, which would limit the maximum deduction to $400,000 for individuals, $500,000 for joint returns, $250,000 for a married individual filing separately, and to a mere $10,000 for a trust or estate.

This change will apply to tax years beginning after December 31, 2021.

Potential planning solutions: This restriction will seriously limit 199A deductions for high-income taxpayers. And the cap amount for trusts and estates is particularly severe, and it will effectively eliminate the benefit for trust-owned real estate and other trust-owned qualifying business assets. Given this, you must consider what happens when evaluating gifts to trusts of real estate, rental property, or other business assets that would qualify for 199A deduction for QBI, since those assets will now be subject to the harsh $10,000 limitation.

Reach out to us, your Family Business Lawyer™ to find out the best ways to offset the negative impact this change stands to have on your business and/or estate.

4. Increase in Capital Gains Tax Rates

Proposed changes: The new bill would increase the long-term capital gains tax rate from 20% to 25% on individuals with taxable income over $400,000. The increase is set to be effective for the tax year ending after September 13, 2021, and it also applies to qualified dividends. However, the bill includes a transition rule that provides that any transactions completed on or before September 13, 2021—or subject to a binding written contract entered into on or before September 13, 2021 (even if the transaction closes after September 13)—are subject to the prior 20% tax rate.

Any capital gains recognized after September 13, 2021, would be subject to the new 25% rate. So, for example, if you entered into a contract to sell your business in May 2021, and the sale closes in November 2021 and exceeds your exemption, your transaction would be subject to the 20% rate. However, if the bill passes, and you enter into a contract after September 13, your tax rate will be 25%. This applies equally to sales of appreciated stock and other investments.

Potential planning solutions: While it may seem that it's too late to do anything about your capital gains on sales at this point, it's not, but it will require planning. This means if you are selling any assets this year that will result in significant capital gains tax to pay, contact us now to discuss your options. Once the sale happens, it's too late. Don't wait.

5. Restrictions On The Use Of Business Losses

Proposed changes: The bill would permanently disallow "excess business losses" (net business deductions in excess of business income) for noncorporate taxpayers. Under current law, the IRS limits pass-through business net losses which can offset non-business income to $250,000 for individuals or $500,000 for married taxpayers filing jointly. In light of this change, you will no longer be able to offset losses from one business with losses/gains from another business.

That said, the bill would allow taxpayers whose losses are disallowed to carry those losses forward to the next tax year. This change will apply to tax years beginning after December 31, 2021.

Potential planning solutions: Contact us now to coordinate your tax planning with your CPA before the end of 2021.

6. Reduction in Estate and Gift Tax Exclusion

Proposed changes: The bill would dramatically reduce the federal estate and gift tax exclusion from its current level of $11.7 million for individuals and $23.4 million for married couples to its 2010 level of $5 million per individual, adjusted for inflation, which would bring the estate and gift tax "coupon" to roughly $6 million.

The proposed reduction would apply to estates of decedents who die or make gifts after December 31, 2021. This reduction would expose estates and gifts above the exclusion amount to a 40% federal estate tax.

Potential planning solutions: In light of the proposed reduction, individuals with assets in excess of $6 million (including life insurance) should take a "use it or lose it" approach to gifting, and make any gifts before the end of the year to qualify for the higher exclusion rate. That said, some families should consider making such gifts before the legislation is officially passed due to the changes to Grantor Trusts and other estate planning strategies described below. If your estate is already over the $6 million exemption, or you expect it to be in the future, contact us now. Again, do not wait.

7. Tax Savings For S Corporations That Convert to Partnerships

Proposed changes: Not every change proposed by the new legislation is negative, and this is one of them. This provision would allow S-Corporations that elected S-Corp status prior to May 13, 1996 to convert tax-free to a partnership at any time in the two years following passage of the bill. Under the current law, such a move would result in a deemed taxable sale of all of the S-Corporation's assets at the time of conversion.

Potential planning solutions: If you own shares in an S-Corp, this could be a great opportunity. S-Corps can typically convert tax-free to a C Corporation, but C Corporations don't offer the level of flexibility in regards to the distribution and allocation of income compared to entities taxed as a partnership. If you are looking for greater flexibility in this regard and want to take advantage of the new tax savings provided by this provision, contact your Family Business Lawyer™ today for support and guidance on making such a conversion.

8. New Restrictions On Grantor Trusts

Proposed changes: The new bill targets Grantor Trusts and would effectively shut them down as planning vehicles. Currently, a Grantor Trust is a trust that can be considered separate and apart from the Grantor (individual who creates the trust) and contributor to the trust for estate tax purposes, but be considered as owned by the grantor for income tax purposes.

Since the grantor is considered the owner of the trust for income tax purposes, transactions between the trust and the grantor are "disregarded," meaning that assets can be sold or exchanged with the trust, without triggering any income tax consequences. However, that same trust can be used to move assets outside of your estate for estate tax purposes, freezing the value of those assets at their current value, such that when you die any appreciation in the value of those assets is not taxed for estate tax purposes, saving your family 40% or more.

The new bill provides that any Grantor Trust created on or after the date of the legislation's enactment will now be included in your estate for estate tax purposes. Distributions from Grantor Trusts (other than to the grantor or the grantor's spouse) would be treated as gifts made by the grantor, and therefore subject to the gift tax exemption. If the bill is enacted and Grantor Trust ceases to be treated as such during the grantor's life, the grantor would be deemed to make a gift of the trust assets, and sales of assets between a grantor and the Grantor Trust would no longer be disregarded for income tax purposes.

The good news is that under the new bill Grantor Trusts established and funded before the enactment of the new law would be "grandfathered" in, as would promissory notes that are in place at the time of the law's enactment.

Potential planning solutions: Contact us if your assets are above the proposed estate tax exemption amount of approximately $6 million, or you anticipate they will be, so we can move some of your assets outside of your estate this year.

9. Impact To Discounts & Other Estate Planning Vehicles

Proposed changes: The bill would not only affect the use of Grantor Trusts, but it would also eliminate valuation discounts, unless the asset gifted or sold is an "active trade or business." Moreover, depending upon how the legislation is applied and interpreted, the new bill may also prevent planners from being able to use irrevocable life insurance trusts (ILITs)—at least to some degree (more about ILITs below)—as well as Grantor Retained Annuity Trusts (GRATs), Qualified Personal Residence Trusts (QPRTs), and Grantor Charitable Lead Annuity Trusts (CLATs).

Irrevocable life insurance trusts (ILITs) are among the most commonly used irrevocable trusts for estate planning, and since most ILITs have traditionally been structured as Grantor Trusts, these trusts will be largely undermined by the new bill. Since the trust would be included in your estate, new ILITs will no longer be feasible. As a workaround, new ILITs may need to be structured as non-Grantor Trusts to avoid estate inclusion.

However, this structure will create an array of problems. First, it will require the trust to expressly prohibit trust income from being used to pay life insurance premiums on your life as the creator of the trust. Second, for those existing trusts that are grandfathered in, no new gifts should be made to the ILIT, or a portion of the trust assets (including life insurance proceeds) will also be included in your estate.

Potential planning solutions: If your estate plan includes any of these trusts or planning strategies, contact us right away for guidance in amending your estate plan to offset the impact of these changes.

As we approach the end of 2021, if your business or personal finances stand to be impacted by any of these changes, it's imperative that you take action as quickly as possible to ensure that whatever actions need to be taken can be planned and executed before the end of the year. Not only that, but given the number of proposed changes that are coming, financial advisors and estate planners are sure to be extremely busy in the coming months.

Given this, don't wait to schedule an appointment with us, your Family Business Lawyer™. The sooner you meet with us, the sooner we can make certain that you can amend your planning strategies accordingly to minimize the impacts of this new bill on your business and personal finances as well as your estate planning.

Next week in part two, we'll discuss the rest of the changes proposed in this new bill, with a primary focus on the bill's impact on retirement planning.

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