IMPACT ANALYSIS:

What the Biden Tax Proposals Mean to Business Owners and High Income Earners

June 2021

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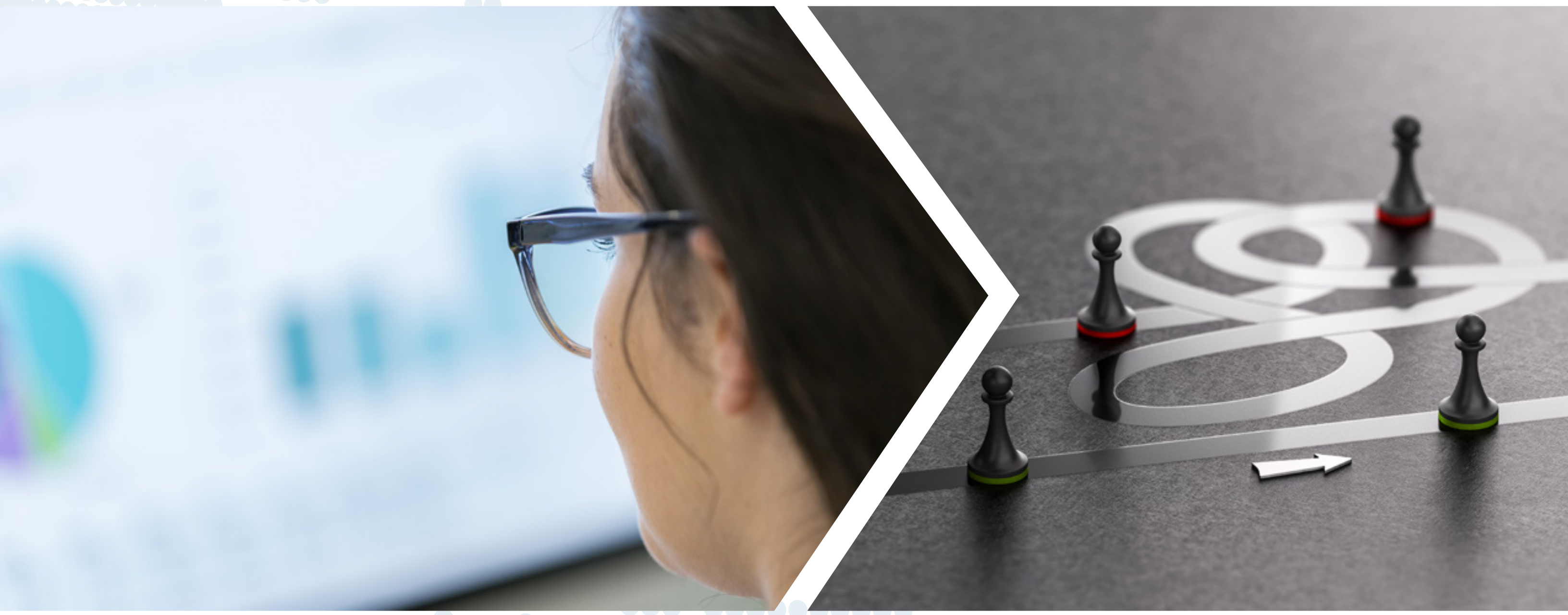

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Analysis of the Biden Administration's Tax Proposals Effect on Businesses and Individuals

President Biden recently announced his $1.8 trillion American Families Plan (AFP), the third step in his Build Back Better policy initiative. The announcement followed the previous releases of the proposed $2.3 trillion American Jobs Plan and the Made in America Tax Plan. These plans propose major investments in various domestic initiatives, such as expanded tax credits for families, offset with tax increases on high-income individual taxpayers, business owners and corporations.

The most recent Treasury report released on May 28, 2021, an annual report commonly referred to as the "Green Book", gives a general explanation of the Biden Administration's fiscal year 2022 revenue proposals for "the American Jobs Plan" and "the American Families Plan" and provides new details on proposed items impacting corporate and individual taxes.

Proposed Tax Changes Affecting the Wealthy and Business Owners

The AFP would reverse many of the provisions in 2017's Tax Cuts and Jobs Act (TCJA 17) and other parts of the tax code that helped to strengthen America's closely-held and family businesses. High income individual taxpayers and small businesses could be negatively impacted by the following changes:

- **Individual Tax Rates.** The plan proposes to return the tax rate for the top income bracket to Obama administration levels, increasing from the current 37% to 39.6%. For 2021, the top tax rate begins at $523,601 for single taxpayers and $628,301 for married taxpayers filing jointly. The new proposed top tax rate will begin at lower level of $452,700 for single taxpayers and $509,300 for married taxpayers filing jointly. This is particularly onerous for taxpayers owning pass-through entities (PTEs) such as S corporations, partnerships and LLCs whose income is taxed on their owner's individual tax return thereby increasing their income.

- **Capital Gains and Qualified Dividend Income.** For those with income in excess of $1 million in a tax year, the AFP would tax long-term capital gains and qualified dividend income as ordinary income - in other words, at 39.6%. Long-term capital gains currently are taxed at a maximum rate of 20% (effectively 23.8%, when combined with the Net Investment Income Tax), depending on taxable income and filing status. Similar to increases in individual tax rates above, this has a significant impact on PTE owners reporting business income on their personal tax returns.

  The following example demonstrates how the increase in capital gains is expected to work. A taxpayer with $800,000 in salary and income from PTEs and $400,000 in long-term capital gain income would have $200,000 of capital gain income taxed at the long-term preferential tax rate and $200,000 taxed at ordinary income tax rates. The "Green Book" indicates this proposal would be effective for gains required to be recognized after the date of announcement. The "Date of Announcement" may be April 28, 2021, the date on which the American Families Plan was announced, or it may be the date the "Green Book" was released on May 28, 2021. In either case, retroactive tax laws may potentially be implemented.

- **Net Investment Income Tax (NIIT).** This tax applies to net investment income to the extent that a taxpayer's modified adjusted gross income (MAGI) exceeds $200,000 for single tax filers, $250,000 for joint filers and $125,000 for married taxpayers filing separately. The NIIT was originally added to the Tax Code to finance the Affordable Care Act. If a taxpayer meets the applicable

MAGI threshold and has net investment income, the amount of NIIT liability is 3.8% of the lesser of 1) the amount by which the MAGI exceeds the threshold or 2) the net investment income.

The AFP proposes to broaden the NIIT by applying it to all types of income greater than $400,000, rather than only investment income. Combined with the hike in capital gains tax, affected taxpayers could face a tax of 43.4% at the federal level. With state and local taxes, high-income individuals could face an overall max capital gains tax rate exceeding 54% in New Jersey and 46% in Pennsylvania.

- **Generational Transfers of Appreciated Assets at Death or by Gift.** Under existing law, the income tax basis of an inherited asset is the asset's fair market value at the time of the deceased's death, not the deceased's original cost for it. This is referred to as "stepped-up basis." As a result of this rule, the gain on appreciated assets isn't subject to taxation if the heir disposes of the assets at death. Conversely, gifts to the next generation during the donor's lifetime retain the donor's basis. This is known as "carryover basis".

  To reduce the incentive to hold appreciated assets until after death — rather than subjecting them to capital gains taxes as a result of sale — the AFP imposes limits on stepped-up basis. Specifically, it ends the practice for income tax free transfer at death when latent gains exceed $1 million, or $2.5 million per couple when combined with existing real estate exemptions. The Biden administration has indicated that it would carve out exceptions for property donated to charities and family-owned businesses and farms.

  Under this proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of "transfer".

  A transfer would be defined under the gift and estate tax provisions and would be valued using the valuation methodologies used for gift or estate tax purposes. However, for purposes of the imposition of this tax on appreciated assets, the following rules would apply:

  - A transferred partial interest would be its proportional share of the fair market value of the entire property.

    Observation: This provision defies economic logic as a minority interest (less than 50%) in a business is not equal proportionately in value to a controlling interest (more than 50%) which has all the decision making power and control the minority interest lacks.

  - Transfers of property into, and distributions in kind from, a trust, partnership, or other non-corporate entity, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would not be recognition events. The deemed owners of such a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or his or her spouse (if the spouse is a U.S. citizen). This provision does not apply to a distribution made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

In an unusual provision, the "Green Book" indicates that gain recognition may apply in more situations than upon death of an individual or a lifetime gift. *"Gain on unrealized appreciation also would be recognized by a trust, partnership or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030."* This provision appears to attempt to capture federal income tax on built-in gain appreciation for assets held in these pass-through entities that has not otherwise been subject to income tax on capital gain recognition.

The proposal would be effective for gains on property transferred by gift or at death by decedents dying, after December 31, 2021, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2022.

Exclusions

There are exclusions to the proposed capital gain rules as follows:

- Transfers by a decedent to a U.S. spouse or to a charity would retain the carryover basis of the decedent. Capital gain would not be recognized until the surviving spouse disposed of the capital asset or dies. Appreciated property transferred to charity would not generate a taxable capital gain.
- Payment of tax on the appreciation of certain family-owned and family-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 transfer of appreciated assets to a split-interest trust would generate a taxable capital gain. There would be an exclusion allowed for the charity's share of the gain based on the charity's share of the value transferred.
- The $250,000 per person exclusion under current law for capital gains on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse. The exclusion, therefore, is effectively $500,000 per couple.
- The exclusion under IRC §1202 of current law for capital gain on certain "small business stock" would be retained.
- The proposal would also allow a $1 million per person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death. The exclusion would be portable to the decedent's surviving spouse, making the exclusion effectively $2 million per married couple. The recipient's basis in property received by reason of the decedent's death would be the property's fair market value at the decedent's death ("stepped up basis"). This rule would also apply to the donee of gifted property to the extent the unrealized gain on that property at the time of the gift was not shielded from being a recognition event by the donor's $1 million exclusion. However, the donee's basis in property received by gift during the donor's life would be the donor's basis in that property at the time of the gift ("carryover basis") to the extent that the unrealized gain on the property counted against the donor's $1 million exclusion from recognition.
- The proposal would exclude from recognition any gain on tangible personal property such as household furnishings and personal effects (excluding collectibles).

Expansion of the Self-Employment Contributions Act (SECA) and Net Investment Income Tax (NIIT)

In addition to Social Security Tax increases for certain earnings levels, the "Green Book" proposes that all pass-through business income of high-income taxpayers will either be subject to the current Net Investment Income Tax (NIIT) or the Self-Employment Contributions Act (SECA) Tax. It states, *"the proposal would ensure that all trade or business income of high-income taxpayers is subject to the 3.8% Medicare tax, either through the NIIT or SECA tax.*

In particular, for taxpayers with adjusted gross income in excess of $400,000, the definition of net investment tax would be amended to include gross income and gain from any trades or businesses not otherwise subject to employment taxes." Meaning the expansion of SECA tax will not be limited to salary and wages only.

Under current law, employees and self-employed individuals pay employment taxes for Social Security and Medicare. The wage limit upon which the 6.2% Social Security tax is paid is $142,800 for 2021. The 1.45% Medicare tax is paid on all earned income without limit. In a substantial departure from past procedure, Biden's tax proposal states Social Security tax will be assessed in two levels. The first on income up to the traditional wage limit ($142,800 for 2021) and after an exclusion up to $400,000, the 6.2% will then be assessed on all salary and earnings above $400,000.

Currently, limited partners and LLC members who provide services to and materially participate in their partnerships and LLCs are subject to SECA tax on their distributive shares of partnership or LLC income. Previous exemptions from SECA tax existing under current law for passive and investment income including rents, dividends, capital gains and certain retired partner income would continue to apply. The statutory exception to SECA for limited partners would not exempt a limited partner from SECA tax if the limited partner is active or materially participates in the business.

Likewise, S corporation owners who are active in the trade or business would be subject to SECA tax on their distributive share of the S corporation's income. The same previous exemptions from SECA tax existing under current law for rents, dividends and capital gains for LLCs would also continue to apply to S corporations.

This proposal would be effective for taxable years beginning after December 31, 2021.

Corporate Tax Proposals

In addition to the individual tax proposals, The Made in America Tax Plan also contains various provisions relevant to businesses. The corporate tax rate being proposed is slated to increase to 28%, which is the midpoint between the current 21% rate enacted during the Trump administration and the pre-2018 tax rate of 35%. The plan also proposes several changes to international taxation, including raising the tax rate on global intangible low-taxed income to 21%, up from 10.5%. Additionally, the AFP would make permanent the limit on excess business loss deductions initially included in TCJA 17 and set to expire in 2025.

The American Jobs Plan, also provides for tax incentives and other support for businesses. For example, it would provide $52 billion to promote domestic manufacturing and $31 billion for small business programs to expand access to credit, venture capital, and research and development funding. It proposes targeted credits related to clean energy generation and storage and expanding the Section 45Q carbon credit. It would also provide an expanded credit for employers that provide workplace childcare facilities.

These changes would be effective for taxable years beginning after December 31, 2021. For C corporations operating on non-calendar years beginning after January 1, 2021 but before January 1, 2022, the tax rate would be hybrid at 21% plus 7% multiplied by income earned in 2022.

Like-Kind Exchanges

Like-kind exchanges, also known as 1031 exchanges, allow a taxpayer to defer the recognition of a gain on the exchange of real property held for use in a business or for investment if the property is exchanged solely for similar property. The AFP would end such deferrals for gains of more than $500,000.

Tax Relief for Individuals and Families

While the AFP would increase the tax liability of high income earning individuals and business owners, it's also designed to help lower income earning individuals. It would do so through a variety of tax credits, including the following:

- **Child Tax Credit (CTC).** The American Rescue Plan Act (ARPA), passed in March 2021, temporarily increased the CTC from $2,000 to $3,000 for eligible taxpayers for each child age six through seventeen and $3,600 for each child under age six. It also makes the credit fully refundable in most cases.

  The child tax credit is subject to a phaseout when income exceeds $400,000 for joint filers and $200,000 for other filers and it is generally refundable up to $1,400 per qualifying child. The ARPA will continue the typical phaseout treatment for the first $2,000 of the credit in 2021 but applies a separate phaseout for the increased amount — $75,000 for single filers, $112,500 for heads of household and $150,000 for joint filers. Under the ARPA, the U.S. Treasury Department will make monthly advance payments for the CTC beginning in July and running through December 2021, based on taxpayers' most recently filed tax returns.

  The AFP would extend these CTC increases through 2025 and make the credit fully refundable on a permanent basis. The proposed extension would include the regular advance payments from the U.S. Treasury Department.

- **Child and dependent care tax credit.** The ARPA expands this credit for 2021. Taxpayers can claim a refundable 50% credit for up to $8,000 (up from $3,000) in child/dependent care expenses for one child or dependent and up to $16,000 (up from $6,000) in child/dependent care expenses for two or more children or dependents — making the credit ultimately worth up to $4,000 or $8,000. The percentage of allowable expenses decreases for higher-income earners — and therefore the value of the credit also decreases. It begins phasing out when household income levels exceed $125,000 and is completely phased out for households with income over $438,000. The dollar amount is the same for all tax filing statuses. The AFP would leave this increase in place permanently.

- **Health insurance tax credit.** The ARPA also increases the availability and the amount of premium tax credits (PTCs) under the Affordable Care Act (sometimes referred to as ACA subsidies or cost-sharing), retroactive to January 1, 2021. It extends PTCs to anyone who receives, or was approved to receive, unemployment benefits in 2021. It also limits the amount that anyone who obtains insurance through the federal or state marketplaces must pay for premiums to 8.5% of their MAGI — regardless of their income. The AFP would make this expansion permanent.

Additional Proposals for Future IRS Funding

The Biden administration proposes providing the IRS with the resources and information it needs to address the "tax gap" (that is, the difference between the tax owed by taxpayers and the amount that is actually paid on time).

The AFP calls for a significant boost in the funding of IRS tax enforcement — $80 billion over 10 years, which, on an annual basis, nearly doubles the IRS's 2021 enforcement budget. The closer scrutiny would focus on large corporations, partnerships and wealthy individuals. It also would require financial institutions to report information on balances and account flows to better track earnings from investments for individuals and business activities.

A comprehensive financial account information reporting regime would be created. Financial institutions would report data on financial accounts in an information return. The annual return would report gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account and transfers to and from another account with the same owner. This would apply to all business and personal accounts from financial institutions, including bank, loan and investment accounts, with the exception of accounts below a de minimis gross flow threshold of $600 or fair market value of $600. Similar reporting requirements would apply to crypto asset exchanges and custodians. Other accounts with characteristics similar to financial institution accounts would also be covered. Also, reporting requirements would apply in cases in which taxpayers buy crypto assets from one broker and then transfer the crypto assets to another broker; businesses that receive crypto assets in transactions with a fair market value of more than $10,000 would have to report such transactions. This proposal would be effective for tax years beginning after December 31, 2022.

As always, Gold Gerstein Group LLC will continue to monitor the tax proposals as they wind their way through Congress, undergo inevitable changes and eventually on to President Biden's desk for signing. Proactive planning will be essential as the proposals and the inevitable changes come closer to becoming law, especially in the estate and gift tax areas.

Please feel free to contact the G3 partner and staff working with you and your business with questions.

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