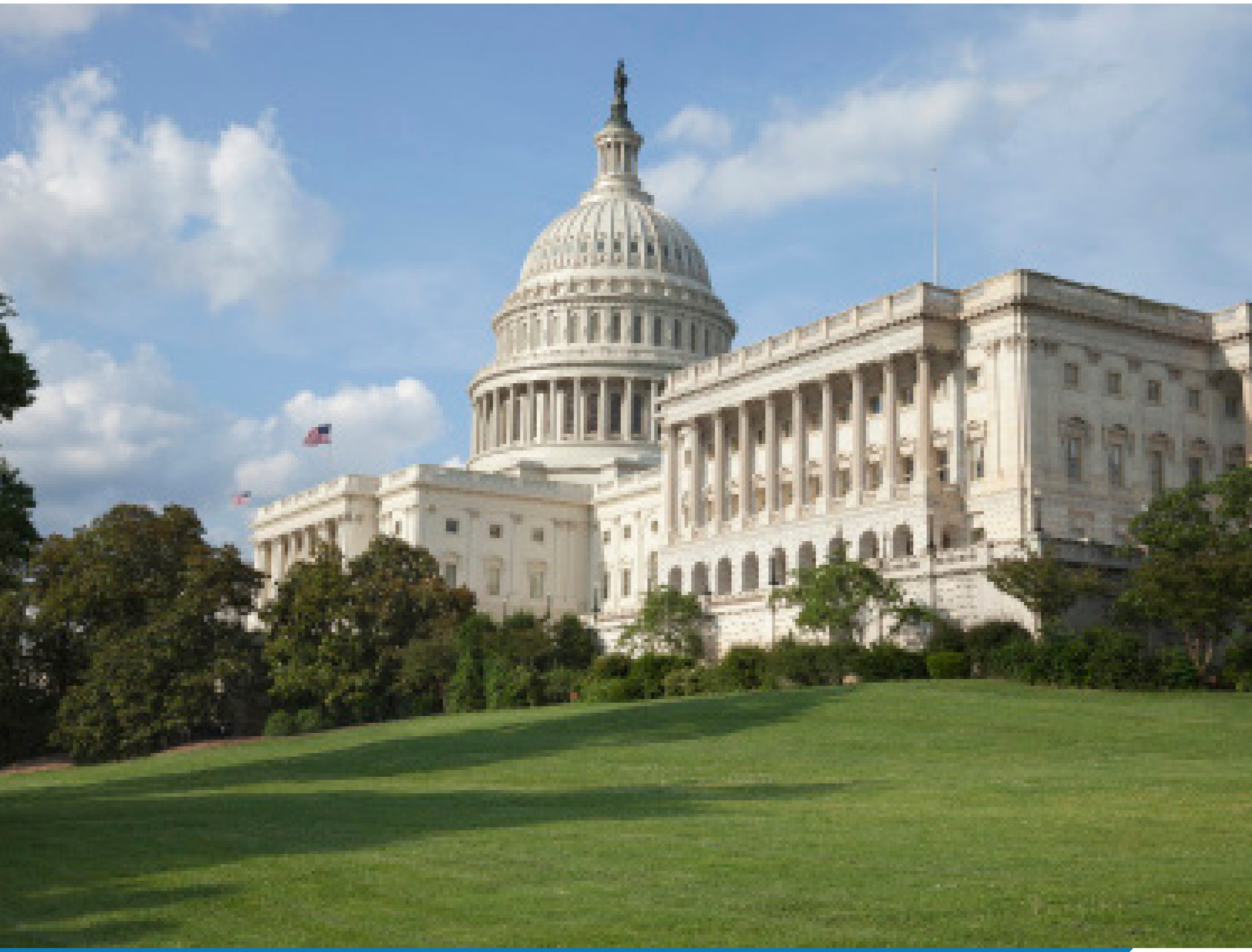


House Ways and Means Committee Proposed Tax Changes

President Biden introduced the American Families Plan this past spring, which called for increases in spending and taxes. Biden's plan was not actual legislation but more of a guide for future legislation. Proposed tax legislation actually originates in the House of Representatives through the House Ways and Means Committee, which recently released draft legislation that would increase taxes to help pay for the proposed $3.5 trillion spending package.

In this document, we'll briefly cover some of the more important proposed tax changes. It's important to note that most of the changes would take effect on January 1st of 2022 unless otherwise noted, and most provisions are limited to higher earners with an adjusted gross income greater than $400K.

Federal Tax Rate

The bill proposes to increase the highest marginal federal tax rate from 37% to 39.6%.

Net Investment Income Tax

The net investment income tax of 3.8% would expand to include income derived in an active trade or businesses of a pass-through entity which is not subject to FICA tax. This would apply to high earners and subject most income from pass-through entities to a 3.8% tax.

New 3% Surtax

The bill introduces a new 3% surtax on modified adjusted gross income in excess of $2,500,000 for married individuals filing separately, $100,000 for estates and trusts, and $5,000,000 for all other individuals.

Capital Gains Tax

The bill proposes to increase the highest capital gains tax rate from 20% to 25% for gains realized after September 13, 2021. If you add the 3.8% Net investment income tax and the new 3% surtax, it would result in an aggregate capital gain tax of 31.8% for the highest earners.

Qualified Business Income Deduction

The qualified business income deduction would be limited to $500K for married filing jointly, $250K for married filing separately, $10K for trusts, and $400K for all others. The QBI deduction is 20% of qualified income, so this would affect business owners with qualified business income in excess of $2 million or $2.5 million, depending on filing status. Trusts cap out at $50,000 of qualified business income.

Lifetime Gift Tax Exemption

The current lifetime gift tax exemption of $11.7 million for individuals and $23.4 million for married couples would expire earlier, resulting in a new lifetime gift tax exemption of $5 million for individuals and $10 million for couples, adjusted for inflation.

Grantor Trusts

For owners of grantor trusts, the assets of a grantor trust, except for a fully revocable trust, are typically not included in the owner's estate. The bill would require assets to be counted as part of the owner's estate and distributions to individuals other than the owner or owner's spouse would be counted as gifts. This would apply to trusts created on or after the date of enactment and to contributions to existing trusts made on or after the date of enactment.

Roth IRA Conversions

The bill proposes to limit and later eliminate Roth Conversations, also known as "Backdoor Conversions" that enable taxpayers to convert a traditional IRA to a Roth IRA. These conversions have long been a popular strategy used by high earners to maximize contributions to a Roth IRA.

Large IRA Accounts

High earners with total IRA and defined contribution balances exceeding $10 million would be prohibited from making additional contributions and would be subject to a higher required minimum distribution.

Qualified Small Business Stock Exclusion

Under current law, the qualified small business stock exclusion enables taxpayers to exclude 100%, and in some cases 75%, of the gain realized from selling qualified small business stock that has been held for at least five years. The bill proposes to eliminate, for high earners, the 100% and 75% exclusions for sales of qualified stock acquired after February 17, 2009, and sold after September 13, 2021, unless the transaction was already subject to a binding contract. Instead, the 50% exclusion rules would apply which significantly reduces the tax benefits and incentives for entrepreneurs and small business investors owning qualified small business stock.

Excess Business Losses

Under current law, excess business losses for noncorporate taxpayers are limited to $500K for married filing jointly and $250K for individuals, indexed for inflation, and losses in excess of those limits may be carried forward. This law is set to expire in 2027, but the bill proposes to make this limitation permanent and change how losses may be carried forward

Corporate Tax Rate

For corporations, the current federal tax rate is 21%. The bill proposes to change this to a graduated structure of 18% for taxable income below $400K, 21% on the taxable income amount from $400K to $5 million, and 26.5% on the taxable income amount in excess of $5 million.

S Corporation Conversion

For S corporations organized prior to May 13, 1996, the bill proposes to permit them to reorganize as partnerships in the two-year period beginning on December 31, 2021, without triggering a tax event. This may help S corporations that have amassed appreciated assets or would like the flexibility of a partnership structure.

Carried Interest

For carried interest, the bill proposes to increase the holding period required to qualify for capital gain treatment from three years to five years. Taxpayers with an AGI less than $400K or who have income attributable to a real property trade or business could still use the three-year holding period.

Business Interest Deduction

The bill proposes to change the business interest deduction limitation so that it would be applied at the partner and shareholder level as opposed to at the entity level. Also, the bill proposes to limit the carryforward period for disallowed business interest to five taxable years for any disallowed interest beginning in 2022. Under current law the disallowed interest carries forward indefinitely.

IRS Enforcement

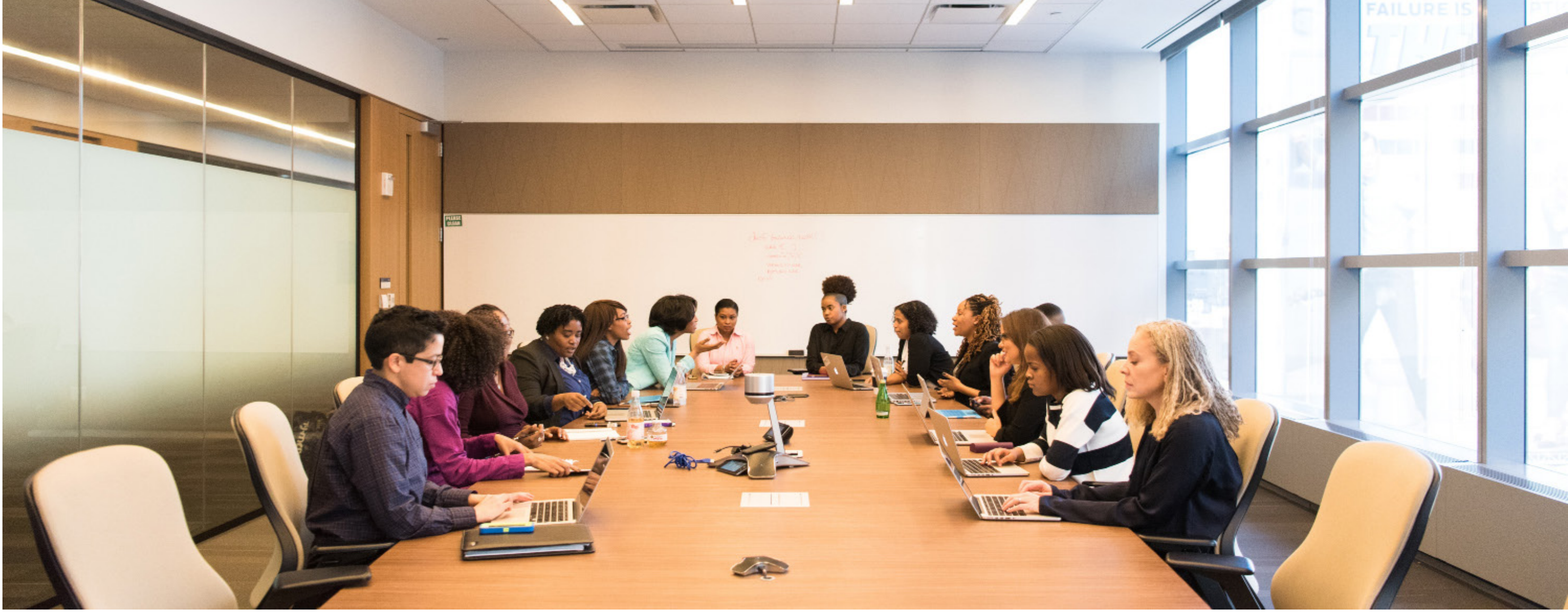
Finally, the bill proposes to allocate an additional $79 billion to the IRS over the next decade to improve technology, increase the number of IRS auditors and enforce tax law compliance. The focus of the enforcement efforts will be on high earners.

Tax Changes Not Included

While the draft bill includes a large number of tax changes, there are certain tax changes that were not included. The elimination of the step-up in tax basis for assets included in a decedent's estate was not included. Limitations on 1031 exchanges were not included nor were changes to the limitation on the state and local tax deduction, known as the SALT cap.

Final Thoughts

This document is meant to provide a brief overview of some of the proposed changes in the draft bill. There are many details to each provision that are not covered. Also, as the draft bill moves through the legislative process, it will certainly be modified and there is no guarantee that the bill will even become law. Regardless, the draft bill provides insight into what might become law and thus can help you with your estate and business planning. If you would like to know more about the proposed changes and how they might affect you or your business, please contact our office. We're always happy to help.



About Pugh CPAs

We got our start in Knoxville, Tennessee in 1969 and have grown into a regional firm with global connections. We've been in business a LONG time and that means we've worked with a diverse group of industries and clients. Of course, we do tax planning, compliance, auditing, and accounting but our passion is collaborating with our clients to ensure that your business and financial goals are met. It's critical for your business advisors to understand how your business operates within your industry—we get that! Our longevity is connected to the relationships we build with our clients and that's how we build trust. You can be confident that Pugh CPAs has the knowledge, skills and abilities to help you achieve your goals. Brilliant people with servant hearts work here.

Pugh CPAs
315 N Cedar Bluff Rd
Suite 200
Knoxville, TN 37923-4548

(865) 769-0660

info@pughcpas.com

www.pughcpas.com