Tax Implications of House Passage of the Build Back Better Act

This morning, the House of Representatives voted 220 to 213 in favor of passing the Build Back Better Act (the Bill). The Congressional Budget Office estimates the bill will cost almost $1.7 trillion and add $367 billion to the federal deficit over 10 years. Although passed by the House, the Bill still has a few hurdles to clear before becoming law. At this point, it is unclear what changes the Senate may incorporate into the Bill or if the Senate even has the requisite votes. The Bill incorporates some of the proposed changes from the September House Ways and Means Committee draft legislation, although most of the major changes have been omitted — including an increase in tax rates, a reduction of the estate and gift tax exemption, and an overhaul of the grantor trust rules. The Bill provides for a number of "new" taxes on corporations and individuals. The Bill also provides the IRS with substantial additional funding. A few of the Bill's provisions related to tax and estate planning are described below.

Provisions Impacting Income Taxes

The Bill contains several provisions which serve to increase income taxes, including:

- Applying a 15% minimum tax on corporations with book income in excess over $1,000,000,000, after applying certain adjustments, for tax years after December 31, 2021. A corporation would owe taxes to the extent that such minimum exceeds the "regular" tax owed by such corporation.

- Imposing a 1% tax on stock buybacks for the fair market value of any repurchased stock by publicly traded U.S. corporations for tax years after December 31, 2021. Such tax may be reduced by the value of new issuance of stock to the public or the employees of the corporation.

- Creating a surtax on high-income individuals, estates, and trusts for tax years after December 31, 2021. A 5% surtax will apply to individuals, trusts, and estates having modified adjusted gross income in excess of certain thresholds — $5,000,000 (married filing separately), $200,000 (for trusts and estates), and $10,000,000 (for all other individual taxpayers — including married filing jointly taxpayers). An additional 3% will be applied on modified adjusted gross income in excess of certain thresholds — $12,500,000 (married filing separately), $500,000 (for trusts and estates), and $25,000,000 (for all other individual taxpayers — including married filing jointly taxpayers).

- Currently, trade or business income earned by an individual who materially participates in a given business is not subject to the 3.8% net investment income tax. Under the Bill, all trade or business income upon which Federal Insurance Contributions Act (FICA) tax is not already imposed is subject to this tax for individual taxpayers with modified adjusted gross income in excess of $400,000 (single taxpayers), $500,000 (married filing jointly or surviving spouse taxpayers), and $250,000 (married filing separately) for tax years after December 31, 2021. The expansion of the net investment income tax will also have an impact on trust and estates by eliminating the material participation exception (i.e., trade or business income of trusts having income above $13,050 will be subject to the tax) for tax years after December 31, 2021. Net operating losses will no longer be accounted for in determining net investment income.

- Subject to the binding contract exception, limiting the 100% gain exclusion for qualified small business stock to 50% for taxpayers with income over $400,000 for sales and exchanges after September 13, 2021.

- Expanding the wash sale rules to cover commodities, currencies, and digital assets (e.g., cryptocurrency) for tax years beginning after December 31, 2021.

- Increasing the state and local tax deduction cap from $10,000 to $80,000 ($40,000 for married taxpayers filing separately and for trusts and estates) through 2030.

Provisions Impacting Retirement Planning

The Bill contains several provisions to curtail perceived retirement account abuses, including the following:

- For tax years beginning after December 31, 2028, generally prohibiting additional contributions to a Roth or traditional IRA for a taxable year if the total value of the individual's IRA and defined contribution retirement accounts exceeds $10,000,000 for single taxpayers 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.

- Imposing a new required minimum distribution requirement on high-income taxpayers with large retirement account balances in tax years beginning after December 31, 2028. If an individual's combined traditional IRA, Roth IRA, and defined contribution retirement account balances exceed $10,000,000 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 exceeds the thresholds described 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 $10,000,000 limit. Additional distributions are required if an individual's combined traditional IRA, Roth IRA, and defined contribution account balance exceed $20,000,000. Any excess over $20,000,000 must be distributed from a Roth IRA or designated Roth account in a defined contribution plan up to the lesser of (1) the amount needed to reduce the total balance in all accounts to $20,000,000, or (2) the total amount held in Roth IRAs and designated Roth accounts in defined contribution plans.

- Closing so-called "backdoor" Roth IRA strategies by eliminating Roth conversions for both IRAs and employer-sponsored plans if the taxpayer's taxable income is above the thresholds described above (e.g., $450,000 for a joint return). The Bill also prohibits all employee after-tax contributions in qualified plans and prohibits after-tax IRA contributions from being converted to Roth regardless of income level.

Prior Tax Proposals Not Currently in Bill

The Bill omits several prior tax proposals, including the following:

- No increase in the maximum 37% personal income tax rate (but remember above surtaxes)
- No increase in the maximum 20% capital gains tax rate (but remember above surtaxes)
- No decrease in estate and gift tax exemptions
- No change to current grantor trust rules
- No elimination of fractional interest discounts for lack of marketability and lack of control
- No elimination of basis step-up at death
- No wealth tax on unrealized gains
- No change to IRC § 199A 20% income tax deduction for qualified business income
- No increase in the 21% corporate income tax rate
- No change to bank reporting requirements

While the Bill still has a few hurdles to clear, it has made it past an important stage. Some of the above changes may not make the final legislation; however, it seems reasonable that a number will remain, and we anticipate future articles detailing the surviving provisions as this Bill progresses.

If you have any questions or concerns about this proposed legislation and how it relates to you, please contact David Hunter, Nick Nester, or your relationship attorney for more information.