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ACCOUNTANTS AND ADVISORS

Tax Notes

Build Back Better – The Current Landscape of Tax Reform

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The House of Representatives passed the Build Back Better (BBB) Bill (H.R. 5376) on Friday, November 19, 2021. The BBB Bill is now before the Senate. While we at PKF Advisory recognize you're getting bombarded with articles about tax legislation, the released Bill reflects a dramatic shift from what many had been expecting for tax reform this year, and we wanted to update you as we approach year-end. To that goal, this newsletter provides a summary of the significant tax aspects of the Bill currently before the Senate.

This summary reflects where the legislation stands after passage in the House of Representatives, but we still urge caution in considering action based on the current version of the Bill. The Senate is still debating substantive provisions of the legislation, and it is likely for the final bill to look different than what the House of Representatives passed. In addition, it appears likely Senate deliberation will extend into 2022, which unfortunately makes year-end planning very difficult.

Note that the BBB Bill is distinct from the Infrastructure Investment and Jobs Act, which had passed the Senate in August, and signed by President Biden.

What's NOT in the House Passed Bill

The leading news on tax reform is that the proposals that primarily concerned many taxpayers are <u>nowhere to be found</u> in the bill including:

- Increase in the top individual ordinary income tax rate to 39.6%
- Increase in the corporate tax rate to as much as 28%
- Increase in long-term capital gains and qualified dividend tax rate
- Taxation of gains in capital assets at death
- Mark to market taxation on stock holdings
- Limitations on Section 1031 exchanges
- Provisions relating to carried interest
- Significant limits to the 20% deduction on pass-through income
- Reduction in estate and gift tax exemptions, as well as changes to the grantor trust provisions

It may turn out your "in the know" friend who told you that you HAD to sell your long-held stock as soon as possible because the capital gain tax rate was "definitely going up retroactively" may have jumped the gun. Of course, just because these provisions are not in the current House Passed Bill does not mean they are completely dead. Negotiations are ongoing, and an increase on the spending side could lead to any one of these provisions being added back. However, it is notable that they have been removed for the moment – at this late stage – after seeming like good bets for much of the year.

Key Individual Income Tax Changes

The main income tax changes for individuals, effective for tax years beginning after December 31, 2021, are generally targeted at those taxpayers with incomes above $400,000. There is also some good news in the increase in the state and local tax deduction cap.

- 5% surcharge on an individual's modified adjusted gross income exceeding $10 million ($5 million for married taxpayers filing separately), and an additional 3% surcharge (8% in total) on an individual's modified taxable income exceeding $25 million ($12.5 million for married taxpayers filing separately).

PKFOD Observation: It is worth noting that modified adjusted gross income does not include any "below the line" deductions such as charitable contributions, state and local taxes, and mortgage interest, creating a higher base of income for the surcharge (similar to the alternative minimum tax). In addition, for trusts and estates, the 5% surcharge applies to trust adjusted gross income in excess of $200,000 and the 3% additional surcharge applies once the trust's adjusted gross income exceeds $500,000. These extremely low thresholds at the trust level mean that distribution planning within complex trusts would be critical going forward.

- Expansion of 3.8% net investment income tax (NIIT) to include income derived from the ordinary course of a trade or business of taxpayers with income over $400,000 ($500,000 for married taxpayers filing jointly), to the extent the income is not already subject to payroll (FICA) tax. The expansion also applies to estates and trusts regardless of income level.

PKFOD Observation: Net investment income currently includes interest, dividends, capital gains, rental and royalty income, and income from businesses that are passive in nature to the taxpayer. It is important to note that this change would subject ALL earnings from pass-through entities (including limited partnership and S corporation allocable share of income) to either the self-employment tax or the NIIT. At first blush, it appears that a taxpayer may be better off paying the self-employment tax, if possible, rather than NIIT because an individual may deduct 50% of the self-employment tax as an above-the-line deduction. This is not the case with the NIIT. Partnership restructuring may need to be considered if this change becomes law.

- Makes permanent the disallowance of excess business losses (originally due to expire after 2025), retroactively to the beginning of 2021. This provision disallows a deduction for the amount of business losses in excess of $250,000 ($500,000 for joint filers) attributable to a trade or business in which the taxpayer actively participates. The CARES Act temporarily repealed this provision for tax years beginning before 2021. In addition, the unused excess losses carried forward would no longer be considered a net operating loss (NOL). Instead, the disallowed losses would be treated as excess business losses in the future, subjecting them to the same cap on usage as current losses. This provision also applies to estates and trusts.

PKFOD Observation: If passed as proposed, this could prove to be a significant limitation on the ability of individual taxpayers to make use of business losses.

- Increases state and local tax (SALT) deduction cap from $10,000 to $80,000 ($40,000 for married filing separately and trust and estate), beginning in 2021 and extending through 2030.

PKFOD Observation: If passed, taxpayers may want to revisit the use of the various state pass-through entity tax regimes and how they are impacted by the increased SALT deduction.

- Reduces the Section 1202 capital gain exclusion to a 50% exclusion for taxpayers with income (other than the income from the Section 1202 sale) greater than $400,000. This provision would be retroactive to September 13, 2021. Currently, the gain exclusion is up to 100%.

PKFOD Observation: This could very much impact future investments in small businesses, as Section 1202 is a powerful incentive for small business investment.

- Prohibits further contributions to a Roth or traditional IRA for a taxable year if the total value of an individual's IRA and defined contribution retirement accounts exceeds $10 million for single taxpayers with taxable income over $400,000 ($450,000 for married taxpayers filing jointly).

PKFOD Observation: In addition to the items listed above, it should be noted that the Bill provides significant funding for increased IRS enforcement, which could lead to an increase in audits.

Corporate Tax Changes

The changes in corporate tax that are broadly applicable across industries are limited in scope. The BBB Bill would impose a 1% corporate excise tax on stock buybacks, but only those by publicly-traded corporations. In addition, there would be a 15% alternative minimum tax, but only on companies with financial statement income of over $1 billion.

The Bill also includes a number of new credits and incentives, as well as a delay until January 1, 2026 of the requirement to capitalize and amortize Section 174 research expenses.

International Tax Reform

There are a number of changes proposed for multinational businesses, many of which align with the goals of the recent Organisation for Economic Co-operation and Development (OECD) agreements relating to global minimum taxes. If enacted, multinational businesses will need to do a full review of their current business structure to understand the impacts of these changes. Broadly speaking, the main impacts will be felt by taxpayers with income in low-tax (below 15%) jurisdictions, who will no longer be able to use tax credits or losses from other jurisdictions to offset the income for U.S. tax purposes.

- Global Intangible Low Tax Income (GILTI) minimum tax rate increased to 15%, and inclusion determined on a country-by-country basis. In addition, the GILTI foreign tax credit allowed would be increased from 80% to 95%.

PKFOD Observation: The cumulative effect of these changes is that a U.S. shareholder of a controlled foreign corporation in a low-taxed jurisdiction is almost assuredly going to have current tax in the U.S. when the foreign corporation is profitable.

- Foreign tax credits limitations applied country-by-country and carryforward limited to 5 years (down from 10 years)
- Deduction for foreign derived intangible income (FDII) reduced from 37.5% to 24.8%
- Base erosion and anti-abuse tax (BEAT) rate increased to 18%

PKFOD Observation: Prior proposals that would have expanded the scope of the base erosion tax rules are not in the current draft of the Bill. Thus, given the threshold for application still requires group gross receipts of $500 million, this will not impact many taxpayers.

- Limits on interest expense for U.S. members of multinational groups

Many of the key changes have effective dates in 2023, providing ample time for taxpayers to consider the consequences of any changes.

Next Steps

Until legislation is signed, we cannot conclude that omission of previous proposals implies that they will be removed from the finalized legislation, nor can we assume that all current proposals will pass. There's still significant negotiations to come. Therefore, our recommendation continues to be to monitor tax policy and be ready to act if needed.

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