Opening Salvos Fired in Individual Tax Reform

April 30, 2021

On April 28, President Biden formally unveiled his individual tax proposals, many of which he had previously outlined in his presidential campaign. The proposals, details of which were not specified, are the revenue-raising provisions to offset the $1.8 trillion cost of The American Families Plan, a spending program designed to "grow the middle class, expand the benefits of economic growth to all Americans, and leave the United States more competitive." These proposals complement the business tax proposals included in the previously released Made in America Tax Plan.

The Tax Policy office in the Treasury Department is reportedly preparing the "Green Book," the document that traditionally contains a more robust description of the Administration's tax proposals. The timing of the release of that document is not known, but it could occur within the next month.

The Tax Proposals

Here is a brief summary of the individual tax increase proposals:

- Impose a 39.6% rate on income above $400,000.
- Tax capital gains and dividends at ordinary income rates for "households" above $1 million, resulting in a tax rate of 43.4% when the net investment income (Medicare) tax surtax of 3.8% is added. It is estimated that this proposal would affect 0.3% of individual income tax filers.
- Treat death and transfers by gift (other than charitable transfers) as income tax realization events for gains in excess of $1 million ($2.5 million per couple when combined with the exclusion for sales of principal residences). Unspecified relief is provided for family-owned businesses and farms when the heirs continue to run the business.
- Close the "carried interest" "loophole" in an unspecified manner.
- Limit the Section 1031 like-kind exchange tax deferral provision to realized gains below $500,000.
- Permanently extend the Section 461(l) $500,000 loss limitation provision.

- Modify the 3.8% Medicare tax to ensure it applies consistently to passthrough income of those making over $400,000.
- Require more robust account flow information from financial institutions.
- Increase IRS funding dedicated to enforcement focused on large corporations, businesses, estates, and higher income individuals.

The following campaign proposals were NOT included:

- Reduce transfer tax exemption to $3.5 million and increase maximum rate to 45%.
- Restore limitation on itemized deductions above $400,000 of income.
- Cap itemized deductions at 28% above $400,000 of income.
- Phase out the qualified business income deduction (section 199A) above $400,000 of taxable income.
- Impose payroll tax withholding for annual incomes above $400,000.
- Repeal the SALT limitation for those with incomes below $400,000.

Here is a brief summary of the major income tax benefits that have been proposed:

- Make Affordable Care Act premium reductions permanent.
- Extend the Child Tax Credit enacted in the American Rescue Plan through 2025 and make the Child Tax Credit permanently refundable.
- Make the Child and Dependent Care Tax Credit expansion enacted in The American Rescue Plan permanent.
- Make the Earned Income Tax Credit expansion for childless workers enacted in The American Rescue Plan permanent.
- Give IRS authority to regulate paid tax preparers.

RELATED LEGISLATION THAT HAS BEEN INTRODUCED OR PROPOSED

The following is a brief summary of the principal provisions of recent introduced or proposed legislation related to individual taxation.

Income Tax Realization at Death or Gift.

Senator Chris Van Hollen (D.-MD) together with Finance Committee members Elizabeth Warren (D.-MA) and Sheldon Whitehouse (D.-RI) and Cory Booker (D.-NJ) and Bernie Sanders (D.-VT) have released a discussion draft of a bill entitled the Sensible Taxation and Equity Promotion (“STEP”) Act. Congressman Bill Pascrell (D.-NJ), a member of the House Ways and Means Committee, has introduced H.R. 2286.

The bills are substantially identical in the following respects: Both would treat a transfer of property at death or by gift as a sale of the property. Exceptions are provided for gifts or bequests to a spouse who is a U.S. citizen, to a charity, and non- business tangible personal property other than property held for investment and collectibles. Each provides an exclusion of $1,000,000 of gain from transfers at death (indexed in the House bill). Losses would be disallowed for gifts between related parties. The Senate bill also provides a $250,000 ($500,000 if married) exclusion for the taxable transfer of a principal residence. The Senate bill would be effective for transfers occurring after December 31, 2020. The House bill would be effective for transfers occurring after December 31, 2021.

Transfer Tax

Senator Bernie Sanders (D.-VT) together with Finance Committee member Sheldon Whitehouse (D.-RI) recently introduced the For the 99.5 Percent Act (S. 994). The bill reduces the estate tax exclusion to $3.5 million and the gift tax exclusion to $1 million. The amounts are not indexed for inflation. The maximum tax rate is raised to 45% for taxable amounts greater than $3.5 million, 50% for taxable amounts greater than $50 million and 65% for taxable amounts greater than $1 billion. The bill also addresses perceived valuation abuses. The increases would be effective for decedents dying and generation-skipping transfers and gifts made after December 31, 2021.

THE LEGISLATIVE PROCESS AND PROSPECTS FOR ENACTMENT

We begin with the standard disclaimer that the tax legislative process is unpredictable. However, we can make the following observations:

Consideration of these individual tax proposals will most likely be deferred until after the Congress has addressed the infrastructure and business tax proposals contained in The American Jobs Plan and the Made in America Tax Plan. While impossible to predict with certainty, and with the possible exception of a repeal in whole or part of the SALT deduction limitation, it is likely that the revenue offsets for this legislation will be limited to the proposals involving business taxation that were proposed the Made in America Tax Plan. The legislative consideration of this initiative is likely to consume considerable time and, of course, the outcome cannot be predicted with certainty. Speaker Pelosi has indicated a July 4 deadline for consideration in the House. If the proposal cannot garner enough support to overcome a filibuster or Budget Act points of order in the Senate, the special "reconciliation" process will have to be used to eliminate procedural constraints for its consideration.

What does this mean for individual tax proposals? The same Senate procedural obstacles that confront The American Jobs Plan will exist. Once again, the reconciliation process may be the only procedural path to enactment. A recent ruling by the Senate Parliamentarian indicates that the reconciliation process might be available for this additional legislation as well as the Made In America Tax Plan, but there is the political question of whether, even if available, the Democrats will attempt to utilize it again. If "reconciliation" is not utilized, the additional legislation will have to proceed in the "regular order", subjecting it to the filibuster and Budget Act points of order in the Senate and making the ultimate passage very difficult. This legislative scenario would indicate that consideration of individual tax initiatives will not occur soon, and that the outcome is uncertain.

Of course, there is no guarantee that proponents of elements of The American Families Plan would not attempt to add one or more of the proposals as revenue offsets to The American Jobs Act, but that appears unlikely at present.

Finally, there is one other lurking legislative imperative to which these proposals could be attached. Legislation to renew the debt ceiling will have to be addressed by July 31. The debt ceiling is generally viewed as “must pass” legislation and therefore becomes a possible vehicle for unacted tax proposals outside the reconciliation process.

If you have questions, please contact Hank Gutman, or a member of our team.