

Tax Proposals Under the “Build Back Better Act” Version 2.0

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On October 28, 2021, the House Rules Committee released a revised version of H.R. 5376, the “Build Back Better Act.” The revised bill makes significant changes to, and departures from, the tax proposals approved in the September 13, 2021 version (the “September version”),^[1] not to mention brushing aside the Senate Finance Committee’s “Billionaires Tax” proposal released on October 27, 2021.

WHAT IS IN

The bill adds several new provisions along with substantially modifying provisions—though keeping some intact—in the September version, including, but not limited to:

Individuals

- **Surtax on High Income Taxpayers.** Revises the September version’s proposal to impose a 5% tax on modified adjusted gross income² in excess of \$10 million (\$5 million for taxpayers filing as married filing separately). An additional 3% tax would apply to modified adjusted gross income over \$25 million (\$12.5 million for taxpayers filing as married filing separately).
- **Application of 3.8% Net Investment Income (“NII”) Tax to Trade or Business Income.** Currently, trade or business income earned by an individual that materially participates in a given business (generally, that spends 500 hours or more per year on that business) is not subject to the 3.8% tax on NII. A carryover from the September version, that exception would be eliminated, and all trade or business income would be subject to the 3.8% tax. The NII tax already applies to investment income (e.g., interest, dividends, and capital gains). Under the revised bill, the new NII tax treatment for trade or business income would apply to taxpayers earning more than \$400,000 annually (\$500,000 for married filing jointly). Net operating losses would no longer be accounted for in determining NII.

Trusts

- **Surtax on Non-Grantor Trusts.** A 5% tax would apply to the adjusted gross income of a non-grantor trust in excess of \$200,000. An additional 3% tax would apply to the adjusted gross income of a non-grantor trust in excess of \$500,000.
 - Trust distributions generally shift income (other than capital gains²¹) from a trust to the beneficiary to whom a distribution is made.
 - Given the much higher thresholds at which the 5% and 3% surtaxes would apply to individual income, the relatively low thresholds at which the surtaxes would apply to trusts may create an incentive to make larger distributions to trust beneficiaries.
- **Application of 3.8% NII Tax to Trade or Business Income.** Currently, trade or business income earned by a non-grantor trust that materially participates in a given business (determined with reference to the trust fiduciaries that control trust decisions with respect to that business) is not subject to the 3.8% tax on net investment income. That exception would be eliminated, and all trade or business income would be subject to the 3.8% tax. The NII tax would continue to apply to trust income over a relatively low threshold (currently \$13,050—subject to typically modest adjustments to account for inflation). Net operating losses would no longer be accounted for in determining NII.

Corporations

- **Corporate Alternative Minimum Tax.** Imposes a 15% alternative minimum tax on the excess of “adjusted financial statement income” (calculated under Section 56A) over the corporate AMT foreign tax credit for corporations with a three-year average of such financial statement income in excess of \$1 billion. The three-year average income threshold is reduced to an amount in excess of \$100 million for “foreign-parented corporations.”
- **Stock Redemption Excise Tax.** Imposes a 1% excise tax on publicly traded U.S. corporations based on the value of the stock that is repurchased by the corporation.
- **GILTI and FDII Modifications.** Among other changes, reduces the Section 250 deduction with respect to both FDII (to 24.8%) and GILTI (to 28.5%), which for GILTI is a substantial departure from the September version’s modest proposal of 37.5%. In combination with the current corporate rate, this yields an effective 15% GILTI rate and 15.8% FDII rate. Both rates are lower than originally proposed in the September version, which also factored in the then-proposed corporate tax rate of 26.5%.
 - Carried over from the September version is the reduction in QBAI exemption from 10% to 5%. And an amendment to Section 951A to provide for country-by-country application of the GILTI regime.
- **BEAT Changes.** Retains, but modifies slightly, the September version’s amendments to the BEAT regime. Notable is the increase to BEAT rates—which are amended to 10% in taxable years beginning after December 31, 2021, and before January 1, 2023; to 12.5% in taxable years beginning after December 31, 2022, and before January 1, 2024; to 15% in any taxable year beginning after December 31, 2023, and before January 1, 2025; and to 18% in any taxable year beginning after December 31, 2024.

Other Business Tax Provisions

- **Portfolio Interest.** Consistent with the September version, the revised bill modifies the definition of “10-percent shareholder,” whose interest is exempt from portfolio interest. For an obligation issued by a corporation, any person who owns 10% or more of the total vote or value of the stock of such a corporation is not eligible for the portfolio interest exemption.
- **1202 Stock.** Carries over the language from the September version, including the September 13, 2021 effective date, by amending Section 1202(a) to provide that the special 75% and 100% exclusion rates for gains realized from certain qualified small business stock will not apply to taxpayers with adjusted gross income equal to or exceeding \$400,000 for sales and exchanges after September 13, 2021, subject to a binding contract exception. The baseline 50% exclusion remains available for all taxpayers.
- **Interest Expense Limitations.** Adds a new Section 163(n) that subjects members of a foreign reporting group to additional limitations on their business interest expense deductions. Also changes the application of the

Section 163(j) limitation for flow-through entities so that the limitation is applied at the partner or shareholder level rather than the entity level.

Appropriations

- **IRS.** Appropriates \$78.946 billion for necessary expenses for the IRS to strengthen tax enforcement activities, increase voluntary compliance, and modernize information technology to effectively support enforcement activities. The use of these funds is not intended to increase taxes on any taxpayer with taxable income below \$400,000. Also appropriates \$15 million for the IRS to prepare and deliver a report to Congress on the cost of developing and running a free direct electronic-filing tax return system.
- **Treasury.** Appropriates \$403 million for necessary expenses for the Treasury Inspector General for Tax Administration to provide oversight of the IRS. And appropriates \$104,533,803 to the Treasury's Office of Tax Policy to carry out functions related to promulgating regulations under the Code.
- **Tax Court.** Appropriates \$153 million for the Tax Court.

WHAT IS OUT

As important as what is in the bill, and the potential reform to the U.S. tax system that it brings, is what has been excluded from the previous version of the bill. Major proposals left on the cutting-room floor, among others, include:

Individuals/Trusts

- **Top Marginal Individual Income Tax Rate Increase.** The September version increased the top rate to 39.6%, which would have applied to married individuals filing jointly with taxable income over \$450,000, heads of households with taxable income over \$425,000, unmarried individuals with taxable income over \$400,000, married individuals filing separate returns with taxable income over \$225,000, and estates and trusts with taxable income over \$12,500 and would have applied to taxable years beginning after December 31, 2021. But see the surtax proposal discussed above.
- **Capital Gains Rate Increase.** Increased to 25% from the current 20% rate, with retroactive application to gains arising from transactions occurring after September 13, 2021, subject to a binding contract exception. But see the surtax proposal discussed above.
- **Grantor Trust Changes**
 - Grantor trusts are a commonly used estate planning technique. While contributions to grantor trusts are subject to gift tax (to the extent that the amount contributed exceeds the grantor's available gift tax exemption), the assets of a properly structured irrevocable grantor trust are generally not subject to estate tax upon the death of the grantor and not subject to generation-skipping transfer ("GST") tax (assuming that the GST exemption is allocated to the initial gift to the trust).
 - Depending on the state in which such a trust is established, the assets of a grantor trust might never be subject to gift, estate, or GST tax.
 - The grantor of a grantor trust can sell assets to that trust without incurring income tax (because under current rules, the assets of that trust are treated as owned by the grantor for income tax purposes and, therefore, the sale is disregarded).
 - The grantor of a grantor trust is obligated to pay the income taxes associated with the trust income. Accordingly:
 - The grantor's estate that will otherwise be subject to estate tax shrinks by the income taxes paid.
 - No gift tax is owed with respect to the income taxes paid.
 - The grantor trust assets grow on an income tax-free basis.

- Under the September version, the following changes would have been made to grantor trusts, which would largely have eliminated the use of grantor trusts as an estate planning tool.
 - Trust assets attributable to contributions made by the grantor after the date of enactment would have been subject to estate tax upon the grantor's death.
 - Sales of assets between a grantor trust and its deemed owner would have been subject to income tax.⁴¹
 - In-kind payments of appreciated assets from a grantor retained annuity trust⁴² would have been subject to income tax.
- **Accelerated Reduction in Gift, Estate, and GST Exemptions.** The gift, estate, and GST exemptions would have been cut in half from their current levels of \$11.7 million to approximately \$6 million (i.e., \$5 million plus an inflation adjustment). Those exemptions, under the 2017 Tax Cuts and Jobs Act, would still be reduced to \$5 million plus an inflation adjustment beginning in 2026.
- **Anti-Discounting Rule Modifications.** A commonly used estate planning strategy involves selling closely held business interests to an irrevocable trust on a discounted basis. Likewise, minority positions in closely held businesses owned at death (and therefore subject to estate tax) are typically subject to valuation discounts to account for the noncontrolling nature of assets of that type and the fact that they are not readily marketable. Under the previous bill, those discounts would have been eliminated to the extent attributable to "passive assets" owned by the business.

Corporations

- **Corporate Tax Rate Increase.** The September version replaced the flat corporate income tax with the following graduated rate structure: 18% on the first \$400,000 of income; 21% on income up to \$5 million, and 26.5% on income thereafter. The benefit of the graduated rate would have phased out for corporations making more than \$10 million.

Other Business Tax Provisions

- **Carried Interest (Section 1061) Modifications.** Sought to (i) extend from three to five years the holding period required for gain attributable to an applicable partnership interest to qualify for long term capital gain treatment; (ii) add rules for measuring the holding period, including in the context of tiered partnerships; and (iii) modify the rules applicable to sale or exchange transactions and extend regulatory authority to address carry waivers and arrangements that avoid the purposes of Section 1061.
- **S Corporation to Partnership Conversions.** Would have allowed certain S corporations organized prior to May 13, 1996, to reorganize as domestic partnerships without triggering tax during a two-year period beginning on December 31, 2021.
- **199A.** Would have amended Section 199A to provide for maximum allowable deductions of \$400,000 (single filer), \$500,000 (joint filer), and \$10,000 for trusts and estates.

These proposals are as of October 28, and subject to change or amendment and modifications may be forthcoming. Indeed, on November 3 a revised draft of the Build Back Better Act was released. An update from Winston & Strawn on those changes to the October 28 proposal is forthcoming.

⁴¹ For more on the September version of the Act, please see our alert here: <https://www.winston.com/en/thought-leadership/house-ways-and-means-committee-tax-proposal.html>

⁴² Adjusted gross income reduced by any deduction allowed for investment interest.

⁴³ Although the shifting effect might also apply to capital gains in certain circumstances (e.g., the trustee has the power to treat capital gains as trust accounting income or consistently accounts for capital gains as trust accounting income).

As written, the September version would apply this treatment only to the extent that the sale was between a post-enactment grantor trust (or post-enactment portion of a grantor trust) and the trust's deemed owner, although it was commonly understood that changes to the September version would have been made prior to enactment to apply this treatment to all grantor trusts regardless of the date of creation.

A grantor retained annuity trust generally provides for annual annuity payments to the grantor calculated based on a rate equal to 120% of the midterm applicable federal rate (referred to as the "7520 Rate," e.g., 1.4% for November 2021). Generally, to the extent that the assets of a given GRAT earn more than the 7520 Rate during the GRAT term, the excess is generally distributed to a trust that will not be subject to estate tax upon the grantor's death.

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