Situation analysis

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Understanding new potential tax law changes

New proposals released by the Biden administration could affect individuals, business owners, estates and capital markets

After legislation designed to drastically alter the tax code failed to pass Congress in 2021, new proposals have been brought to the table by President Joe Biden's administration. These potential changes were outlined by the U.S. Department of the Treasury in March 2022 in a document commonly referred to as "The Green Book." This is a summary of the administration's tax proposal presented as part of the budget for fiscal year 2023.

The revenue proposals reflected in the Green Book are being presented to Congress for its consideration and approval during the course of the year. Additional tax legislation that may match or differ from some of the Green Book proposals is likely to be developed and reviewed as well by Congress in the months to come.

Although there is no clear timeline for when any legislation is expected, or even any certainty that new tax policies will gain Congressional approval, it's important to be prepared for potential changes that could affect your tax liability.

Who could be affected by these proposed changes?

The proposals included in the Green Book cover a wide range of tax laws, though the impact will be felt mostly by a narrow group of taxpayers. Nevertheless, the changes may be of concern to you if you meet any of these criteria:

- Have adjusted gross income equal to or exceeding $400,000 for single tax filers or $450,000 for those who are married and filing a joint return
- Itemize deductions on your federal tax return
- Have current or planned trusts
- Are an owner of a limited partnership, limited liability corporation (LLC), "S" corporation or "C" Corporation

Note that the proposed effective dates of various changes to the law are not consistent. While most would take effect after December 31, 2022, some could become effective at an earlier date. Note the effective dates as you review the provisions below.

Here are highlights of the tax provisions included in the U.S. Treasury Department's 2023 Green Book:

Tax rates for individuals

Increase in the top marginal income tax rate

One of the most notable changes for higher income taxpayers is that tax rates would likely go up. Under current law, the top marginal tax rate is 37%. The thresholds at which the top tax bracket applies in 2022 are:

- $539,900 for single taxpayers (other than surviving spouses)
- $647,850 for married taxpayers filing a joint return
- $539,900 for heads of household
- $323,925 for married couples filing a separate return.

The Green Book proposals would raise the top tax bracket to 39.6% from the current 37% level, and reduce the applicable income thresholds to:

- $400,000 for single tax filers (other than surviving spouses)
- $450,000 for married couples filing a joint return
- $425,000 for heads of household
- $225,000 for married couples filing separate returns.

The new tax brackets would apply after December 31, 2022.

Minimum tax

A new 20% tax rate on total income, generally inclusive of unrealized capital gains, would apply to taxpayers with total wealth (net of liabilities) exceeding $100 million. Provisions include the ability to pay a minimum tax liability in nine equal installments in the first year. In subsequent years, the minimum tax liability would be payable in five equal installments over the course of the year. Payments of the minimum tax liability will be treated as a prepayment credit that can be applied towards subsequent capital gains realized in the future to avoid double taxation of capital gains. Because of various factors that go into the calculation of meeting the $100 million threshold, taxpayers should be aware that the minimum tax is fully phased in for taxpayers with wealth in excess of $200 million.

The proposal would be effective for taxable years beginning after December 1, 2022.

Tax changes that could affect investments

Tax rate on long-term capital gains and qualified dividends

The current top tax rate on long-term capital gains and qualified dividends of 20% would increase to the new top marginal income tax rate on ordinary income — 39.6% for high income taxpayers. With the Net Investment Income Tax of 3.8% included, the total tax would be 43.4%. The higher tax rate would apply only to the extent that an individual's taxable income exceeds the applicable thresholds amount indexed for inflation after 2023:

- $1,000,000 for married couples filing a joint return
- $500,000 for married couples filing separately.

If enacted, it is proposed that this change would apply retroactively for gains and dividends received on or after the date of enactment.

Tax changes that could affect estate transfers and gifting

The current unified gift and estate tax exemption of $12.06 million per person (in 2022) is set to expire at the end of 2025. At that time, the exemption amount will be reduced by roughly half the current level. Previous proposals under consideration would have accelerated the expiration of the higher exemption amount to 2022, but this broad aspect of estate and gift taxation is not addressed by the Green Book. However, a number of other provisions are included.

Tax on unrealized gains

Unrealized gains on appreciated assets transferred by gift during life or held at death would be treated as a "realization event" for tax purposes and taxed as if the underlying property was sold. The unrealized gain of property transferred by gift during life or held at death would be subject to a $5 million lifetime exclusion for a single tax filer. Any unused exclusion during life can be applied towards the unrealized gain on property held at death. Also, the proposed exclusion would be portable and may be used by a surviving spouse. This results in an effective aggregate exclusion amount of $10 million that can be used towards unrealized gains by married couples filing a joint return. Gains on gifts or bequests to charities would not be required to be recognized. Neither would gains on gifts or bequests to a spouse until the spouse dies or disposes of the asset. However, in both cases, the cost basis would carry over. This tax would apply on property transferred by gift after December 31, 2022, or property owned by individuals who die after December 31, 2022.

Previously proposed rule changes *not* included in the Green Book

The Green Book did not address some key changes to the tax code that had been proposed in legislation under consideration in 2021. These include:

Repeal of the cap on Social Security taxes. The 6.2% tax on Social Security for each employer and employee applies to the first $142,800 of income in 2022. While some expected this cap to be removed, nothing to that effect was included under these proposals.

Change to gift and estate tax exemptions and tax rates. As indicated above, the current lifetime unified exemption amounts and tax rates for gift and estate remain at their elevated levels, with the current rules phasing out in 2026.

SALT limitation. There was much discussion of eliminating the maximum $10,000 deduction for state and local (SALT) taxes, but that issue is not addressed in the Green Book.

In addition, unrealized capital gains in appreciated assets would be taxed if they are transferred into or distributed in kind from an irrevocable trust, partnership or other non-corporate entity if such transfers are effectively a gift to the recipient. Similarly, unrealized capital gains in appreciated assets held by an irrevocable trust, partnership or other non-corporate entity would be subject to tax if such property had not been recognized for tax purposes within the prior 90 years.

These rules would become effective on transfers, or for property owned by individuals who die after December 31, 2022.

New rules for donor-advised funds

The use of donor-advised funds (DAF) would be limited to avoid private foundation (PF) payout requirements by clarifying the definition of a distribution from PFs to DAFs. Such distributions would not be considered a qualifying distribution unless the DAF funds are expended as a qualifying distribution in the following taxable year. In addition to meeting that requirement, the PF must maintain adequate records or other evidence to that effect. This rule would be applicable on the date that it is enacted into law.

Tax laws related to GRATs and other trusts

Under current law, the creator of a grantor trust is treated as the owner of the trust assets for income tax purposes. This allows the grantor to manage transactions within the trust without realizing gains and to pay income taxes without it being considered a taxable gift. Several provisions of the new proposals would affect the operation of grantor retained annuity trusts (GRATs) and other types of trusts.

Minimum and maximum value requirement for GRAT

To fully qualify for favorable tax treatment inside the trust, the remainder interest established at the inception of a GRAT must have a minimum value equal to the greater of 25% of the value of assets transferred into the GRAT or $500,000 (but not more than the value of such assets). The term of the GRAT must also be a minimum of 10 years and not exceed the annuitant's life expectancy plus 10 years.

Asset sales in grantor trusts

The sale of an asset between an irrevocable grantor trust and its deemed owner (grantor or any other person) would require the seller to recognize a gain on any appreciation in the transferred asset for income tax purposes. The buyer would be required to claim a cost basis equal to the value of the asset, which would include the satisfaction of an obligation, such as an annuity payment or note repayment, with appreciated property. This rule would not apply to securitized transactions.

Tax treatment of income tax paid by owner

If the deemed owner of the trust pays the income tax due from the trust, this would be considered a gift, unless the trust reimburses the owner for the tax payment in the same year.

Valuation of promissory notes

Promissory notes that bear sufficient interest to avoid below-market status would require consistent valuation. The discount rate used to value the note for gift and estate tax purposes would be the greater of the actual interest rate of the note or the applicable federal rate (AFR) based on the remaining term of the note. The proposal would apply to valuations as of a valuation date on or after the date of introduction.

Limit to generation-skipping transfer tax exemption

The generation-skipping transfer tax exemption would be limited to direct skips and taxable distributions from a GST trust to beneficiaries who are no more than two generations below the transferor (grandchildren). Those of younger generations would qualify for the same tax treatment if they were alive at the creation of the trust. Taxable terminations of a GST trust that occurs while any of these persons are beneficiaries of the trust would also qualify.

All of the above trust-related changes could take effect on or after the date of enactment of the new tax law, unless otherwise specified.

Tax changes that could affect businesses and business owners

The new proposals most notably impact the applicable tax rate for profits of corporations, but also address what are considered "loopholes" in the current tax laws affecting business owners.

Increase in the corporate tax rate

The effective tax rate on net income for C corporations would be increased from 21% to 28%. This would be effective for tax years beginning after December 31, 2022. For taxable years that begin after January 1, 2022, and before January 1, 2023, only the portion of the taxable year in 2023 would be subject to the 28% tax rate.

Limits on family partners to shift tax basis

The ability of family members to use a partnership to shift the tax basis of assets between each other would be reduced effective for partnerships in taxable years beginning after December 31, 2022.

Treatment of carried interests

Under current law, a "profits" interest in partnership received in exchange for services is typically not taxable when received. The recipient is taxed based on their share of partnership income and the character of the income at the partnership level. Under new rules, tax-carried profits interests in a partnership would be treated as ordinary income and be subject to self-employment taxes regardless of the character of the income at the partnership level. This would apply to partners holding the interest and providing services to the partnership who have taxable income exceeding $400,000. The interest would only be treated as a long-term capital gain if there were a three-year holding period. The new law would be effective beginning after December 31, 2022.

Limits on like-kind (1031) exchanges

Section 1031 exchanges allow taxpayers to defer the full value of the gain on the exchange of real property for other real property. Under new rules, the deferral of a Section 1031 like-kind exchange of real property would be limited to an aggregate amount of $500,000 for each taxpayer ($1 million for married couples filing a joint return) per year. This would take effect after December 31, 2022.

Limits on conservation easement transactions

A partner's tax deduction in certain syndicated conservation easement transactions would be limited. A direct or indirect contribution by a partnership would not be treated as a qualified conservation contribution if the amount of the contribution exceeds 2.5 times the sum of each partner's basis in the partnership. There are important exceptions to this proposal. For example, it would not apply if a three-year holding period requirement was satisfied. It also would not apply to certain partnerships and other pass-through entities if substantially all of the interests are held by family members.

The new law would be effective for contributions made in taxable years after December 23, 2016, or in the case of contributions to preserve a certified historic structure, for contributions made in taxable years beginning after December 31, 2018.

Deductions for business-owned life insurance

The pro-rata interest expense deduction disallowance for interest allocable to unborrowed cash values of business-owned life insurance would be expanded. This would be the result of the repeal of an exception currently allowed under IRC Sec. 264(f)(4) for policies covering employees, officers or directors. An existing exception for a policy covering a business owner with 20% of the business would remain. This would be effective for policies issued after December 31, 2021.

Start planning for a changing tax environment

The Green Book is just a starting point for legislation that may come under consideration in 2022. The timing of any legislation is difficult to predict, and much may revolve around the fact that all members of the House of Representatives and one-third of the members of the U.S. Senate are up for election in November. We will closely monitor events in Washington and keep you up-to-date on the latest proposals.

Talk with your wealth professional if you have questions about the potential impact on your own situation and financial plan. We stand ready to assist you and will keep you informed as likely outcomes stemming from the ongoing legislative agenda come into sharper focus.