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Potential Federal Tax Changes: What May Be Coming

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On September 13, 2021 the U.S. House Ways and Means Committee (the "Committee") announced their proposed plan and legislative text for the 2022 Budget Reconciliation Bill (the "Plan").

Budget reconciliation is the process of expediting the passage of fiscal legislation by U.S. Congress. Unlike typical federal legislation, budget reconciliation bills only require a simple majority of the U.S. Senate (51 votes) to pass and reach the President's desk for enactment.

This past August, the U.S. Senate approved a budget resolution to begin the process of preparing the 2022 Budget Reconciliation Bill to fund a proposed $3.5 trillion federal budget. In order to fund the proposed $3.5 trillion federal budget, the Committee's Plan includes numerous federal tax changes, including the pertinent modifications highlighted here:

Long Term Capital Gains

The Plan proposes an amendment to the Section 1(h)(1)(D) of the Internal Revenue Code to **increase the top long term capital gains rate from 20% to 25%.** The new long term capital gains rate will be effective and applicable to gains realized after September 13, 2021.

Federal Estate and Gift Tax

Currently, a person can pass $11.7 million free of federal estate and gift tax. This exclusion amount is adjusted every year for inflation.

The Plan includes an amendment to Section 2010(c)(3) of the Internal Revenue Code which strikes the provision that allowed for a temporary increase in the basic exclusion amount from $5 million to $10 million. Consequently, **if the proposed legislation is enacted, the exclusion against estate and gift tax would go from $11.7 million back to the 2010 amount of $5 million per person, adjusted for inflation.** The reduction in the unified exclusion would be effective January 1, 2022 and would be approximately $6 million.

Negative Tax Treatment of Grantor Trusts

Grantor trusts are recognized for federal estate tax purposes but disregarded for income tax purposes. Grantor trusts allow assets to appreciate outside of the grantor's estate, with the income being taxed to the grantor as opposed to being subject to the compressed income tax brackets of trusts. T**he Plan brings the assets of a grantor trust back into the grantor's taxable estate when the grantor is deemed the owner of the trust.**

Currently, a grantor can sell assets (for example, stock in a closely-held business) to a grantor trust in exchange for a promissory note, which "freezes" the value of the grantor's estate. Because grantor trust are disregarded for income tax purposes, there is not a recognition of capital gain on the sale to the trust. **The Plan seeks to treat the sale between the grantor and the grantor trust the same as if the grantor sold the assets to a third party, meaning that the sale to the grantor trust would likely result in capital gain recognition.**

Unlike the change to the estate and gift tax exclusion, the proposed changes to the tax treatment of grantor trusts will become effective immediately upon the proposed legislation being enacted into law. Grantor trusts created and funded prior to effective date will be grandfathered, however, the trusts cannot be adjusted and no contributions can be made to the trusts after the proposed legislation is enacted. **This is significant because most life insurance trusts are grantor trusts.**

Increase of the Corporate Tax Rate

The Committee has included in its Plan a **modification to the corporate tax rate structure** that will be applied as follows:

- 18% on the first $400,000 of corporate income;
- 21% on corporate income up to $5 million; and
- a rate of 26.5% on corporate income thereafter.

The benefit of the foregoing graduated rate is not applicable to corporations receiving income in excess of $10 million.

Increase in the Top Marginal Individual Income Tax Rate

The Plan will **increase the top marginal individual income tax rate to 39.6%.**

The top marginal individual income tax rate applies to taxable income over $450,000, to heads of households with taxable income over $425,000, to unmarried individuals with taxable income over $400,000, to married individuals filing separate returns with taxable income over $225,000, and to estates and trusts with taxable income over $12,500. The new top marginal individual income tax rate is proposed to be effective for taxable years after December 31, 2021.

2022 Budget Reconciliation Bill may be enacted “as is” or will be subject to further modifications in both the U.S. House of Representatives and Senate. However, it is important to be aware of all of the proposed changes above for future tax planning purposes.

If you have questions about how this update and how it could affect your business or estate plan, please contact your Knox Law attorney or call us at 814-459-2800.
