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Advancing Tax Proposals Put Corporations and High-Income Individuals in Spotlight

A number of advancing tax proposals have put corporations and high-income individuals in the spotlight.

On Saturday, September 25, 2021, the House Budget Committee voted to advance a $3.5 trillion spending package to the House floor for debate. The House Ways and Means Committee and the Joint Committee on Taxation had previously released summaries of proposed tax changes intended to help fund the spending package. Many of these provisions focus specifically on businesses and high-income households.

Expect these proposals to be modified; some will likely be removed and others added as the legislative process continues. As we monitor progression through the legislative process, though, here are some highlights from the previously released proposed provisions worth noting.

Corporate Income Tax Rate Increase

Corporations would be subject to a graduated tax rate structure, with a higher top rate.

Currently, a flat 20% rate applies to corporate taxable income. The proposed legislation would impose a top tax rate of 26.5% on corporate taxable income above $5 million. Specifically:

- A 16% rate would apply to the first $400,000 of corporate taxable income
- A 21% rate on remaining taxable income up to $5 million
- The 26.5% rate would apply to taxable income over $5 million, and corporations making more than $10 million in taxable income would have the benefit of the lower tax rates phased out.

Personal service corporations would pay tax on their entire taxable income at 26.5%.

Tax Increases for High-Income Individuals

Top individual income tax rate. The proposed legislation would increase the existing top marginal income tax rate of 37% to 39.6% effective in tax years starting on or after January 1, 2022, and apply it to taxable income over $450,000 for married individuals filing jointly, $425,000 for heads of households, $400,000 for single taxpayers, and $225,000 for married individuals filing separate returns. (These income thresholds are lower than the current top rate thresholds.)

Top capital gains tax rate. The top long-term capital gains tax rate would be raised from 20% to 25% under the proposed legislation; this increased tax rate would generally be effective for sales after September 13, 2021. In addition, the taxable income thresholds for the 25% capital gains tax bracket would be made the same as for the 39.6% regular income tax bracket (see above) starting in 2022.

New 3% surtax on income. A new 3% surtax is proposed on modified adjusted gross income over $5 million ($2.5 million for a married individual filing separately).

3.8% net investment income tax expanded. Currently, there is a 3.8% net investment income tax on high-income individuals. This tax would be expanded to cover certain other income derived in the ordinary course of a trade or business for single taxpayers with taxable income greater than $400,000 ($500,000 for joint filers). This would generally affect certain income of S corporation shareholders, partners, and limited liability company (LLC) members that is currently not subject to the net investment income tax.

New qualified business income deduction limit. A deduction is currently available for up to 20% of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20% of aggregate qualified real estate investment trust dividends and qualified publicly traded partnership income. The proposed legislation would limit the maximum allowable deduction at $500,000 for a joint return,

$400,000 for a single return, and $250,000 for a separate return.

Retirement Plans Provisions Affecting High-Income Individuals

New limit on contributions to Roth and traditional IRAs. The proposed legislation would prohibit those with total IRA and defined contribution retirement plan accounts exceeding $10 million from making any additional contributions to Roth and traditional IRAs. The limit would apply to single taxpayers and married taxpayers filing separately with taxable income over $400,000, $450,000 for married taxpayers filing jointly, and $425,000 for heads of household.

New required minimum distributions for large aggregate retirement accounts.

- These rules would apply to high-income individuals (same income limits as described above), regardless of age.
- The proposed legislation would require that individuals with total retirement account balances (traditional IRAs, Roth IRAs, employer-sponsored retirement plans) exceeding $20 million distribute funds from Roth accounts (100% of Roth retirement funds or, if less, by the amount total retirement account balances exceed $20 million).
- To the extent that the combined balance in traditional IRAs, Roth IRAs, and defined contribution plans exceeds $10 million, distributions equal to 50% of the excess must be made.
- The 10% early-distribution penalty tax would not apply to distributions required because of the $10 million or $20 million limits.

Roth conversions limited. In general, taxpayers can currently convert all or a portion of a non-Roth IRA or defined contribution plan account into a Roth IRA or account without regard to the amount of their taxable income. The proposed legislation would prohibit Roth conversions for single taxpayers and married taxpayers filing separately with taxable income over $400,000, $450,000 for married taxpayers filing jointly, and $425,000 for heads of household. [It appears that this proposal would not be effective until 2032.]

Roth conversions not allowed for distributions that include nondeductible contributions. Taxpayers who are unable to make contributions to a Roth IRA can currently make "back-door" contributions by making nondeductible contributions to a traditional IRA and then shortly afterward convert the nondeductible contribution from the traditional IRA to a Roth IRA. It is proposed that amounts held in a non-Roth IRA or defined contribution account cannot be converted to a Roth IRA or designated Roth account if any portion of the distribution being converted consists of after-tax or nondeductible contributions.

Estates and Trusts

- For estate and gift taxes (and the generation-skipping transfer tax), the current basic exclusion amount (and GST tax exemption) of $11.7 million would be cut by about one-half under the proposal.
- The proposal would generally include grantor trusts in the grantor's estate for estate tax purposes; tax rules relating to the sale of appreciated property to a grantor trust would also be modified to provide for taxation of gain.
- Current valuation rules that generally allow substantial discounts for transfer tax purposes for an interest in a closely held business entity, such as an interest in a family limited partnership, would be modified to disallow any such discount for transfers of nonbusiness assets.

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