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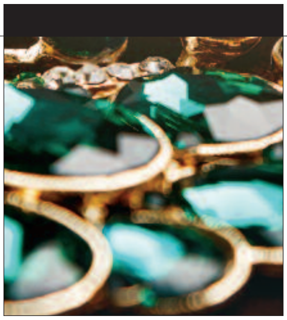

Build Back Better: Challenges and Opportunities for Private Wealth Clients

A review of potential legislative changes and impact to planning for high net worth and high earning clients.

KAREN HARDING

After extensive wrangling and many false starts, Congress is well on its way to implementing large-scale tax reform and public investment programs that have been promoted by the Biden administration. For private wealth clients, recently passed legislation is likely to present both new challenges and compelling investment opportunities. In this piece, the author will highlight the changes planners need to know about now, and what to be monitoring in the years ahead.

The Big Picture — Legislation and Motivation

The $1.75 trillion Build Back Better bill, which passed the House in November, represents a smaller version of the original $3.5 trillion bill. It eliminates many of the original proposal's restrictions on the estate planning tools that enable taxpayers to protect and pass along their wealth. It also no longer includes the higher rates on ordinary income and capital gains that were in the original version, though a surtax on the highest earners remains.

While the bill has been scaled back, the legislation may nevertheless signal the beginning of a new political era. Some observers cite political cycles of the past in which the federal government has taken a more activist role in the economy, addressing issues such as income inequality.[1] If so, it's still possible that proposals that have been eliminated from the current bill could be considered at a later date.

The recently passed infrastructure bill, part of the American Jobs Plan in the Build Back Better agenda, may also mark the beginning of a more activist era. After years of discussion, a bill has finally been passed that may now address longstanding needs for upgraded roads, bridges, and the like. It also addresses renewable energy, housing, and other areas. These programs are likely to create a variety of investment opportunities.

Of course, political winds are blowing in the other direction as well, but high-net-worth individuals would be well-advised to keep all of these provisions on their radar to protect their wealth and take advantage of areas that may offer investment potential.

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The legislation discussed in this article was pending at the time of publication.

High-Income Earners

Under Consideration

A 5% income tax surcharge. For individuals, a 5% surcharge would be imposed on modified adjusted gross incomes of more than $10 million. An additional 3% surcharge would be levied on modified adjusted gross incomes over $25 million. The bill would also eliminate a loophole that allows higher earners to avoid a 3.8% Medicare tax.

A 3. 8% Net Investment Income Tax (NIIT). For individuals earning more than $400,000, a 3.8% tax on business income would apply. Business losses would no longer be considered in determining this tax. This tax currently applies to investment income of those who earn a large amount of income from their investments. It covers dividends, interest, and capital gains, and can also apply to annuity and rental income.

A higher cap on federal deductions for state and local taxes. The Tax Cuts and Jobs Act of 2017 put a $10,000 cap on the deductibility of state and local taxes. This harmed high income individuals in states with high state and local taxes. The new proposal would be beneficial to those individuals as it could raise the cap to $80,000, make it effective retroactively to December 31, 2020, and extend it for 10 years.

Greater IRS enforcement. The bill would allocate $80 billion more to the Internal Revenue Service for hiring auditors, improvement of customer service, and updating technology. Some have estimated that $400 billion in new revenue could be collected by increasing compliance. The Congressional Budget Office has estimated that it would bring in a net of only another $127 billion after taking the $80 billion in new funding into account.

Proposals to Watch

The top personal rate could rise. The initial proposal would have increased the top personal rate from 37% to 39.6%. This rate would have applied to individuals earning more than $400,000 and to married persons filing jointly earning more than $450,000.

The capital gains rate could go up. A higher tax rate on capital gains was initially considered that would raise the rate from 20% to as high as 28%.

The holding period for carried interest could be extended. As originally considered, the proposal would have increased the holding period for carried interest from three years to five years to qualify for taxation at capital gains rates.

A tax on unrealized capital gains could be imposed. A proposal could require that unrealized gains on assets be taxed every year. As originally proposed, this would have applied to taxpayers with $1 billion in assets or $100 million in income.

Estates and Trusts

Under Consideration

A 5% income tax surcharge. For estates and trusts, the proposed law would impose a 5% surcharge on any modified adjusted gross income that exceeds $200,000 and an additional 3% surcharge on incomes above $500,000. This could significantly increase income taxes on non-grantor trusts if they do not distribute income to beneficiaries.

A 3. 8% Net Investment Income Tax (NIIT). Business income earned by a non-grantor trust would no longer be exempt from the NIIT.

Proposals to Watch

Grantor trusts: Taxes on capital gains. The original proposal made drastic changes to the tax treatment of grantor trusts. These have been eliminated, but similar proposals could return at a later date.

Grantor trusts have long been used by estate planners to protect their clients' wealth. One advantage of these trusts is that transactions between the grantor and the trust are not treated as taxable events. This has enabled grantors to transfer assets into trusts, reducing their taxable estate, without triggering a taxable event, thus avoiding capital gains liabilities.

Estate planners have historically also swapped high-basis assets into a trust in exchange for low-basis assets. Historically, this type of transfer has not triggered capital gains taxes. The original proposal would have taxed those capital gains.

The initial proposal also would have made a large impact on grantor retained annuity trusts (GRATs), a technique often used to reduce the size of a person's taxable estate, essentially prohibiting the use of GRATs to move assets out of the taxable estate. It would also have affected a variety of other estate planning tools, including insurance trusts, which are set up to make sure that a death benefit on an insurance policy will not be subject to the estate tax.

Exemption from gift and estate taxes could be cut. Under the Tax Cuts and Jobs Act of 2017 signed into law by President Trump, the exemption on transfer taxes was temporarily doubled to $10 million per person. Adjusted for inflation, this made the gift and estate exemption $12.06 million per person ($24.12 million per couple) in 2022. This temporary provision is set to expire in 2026, cutting the current deduction in half.

The reduction in the exemption would make many more households liable for estate taxes. If subsequent legislation restricted traditional estate planning tools, such as grantor trusts, families would be left with less effective means of protecting and passing along wealth.

Corporations and Small Businesses

Under Consideration

A minimum corporate tax rate. The current 21% corporate rate would remain, leaving the reduction enacted

[1] Dalio, "Biden = Roosevelt (The Analogue)," https://www.linkedin.com/pulse/biden-roosevelt-analogue-ray-dalio/


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in the 2017 tax law unchanged, but a minimum rate of 15% would be imposed on corporations averaging more than $1 billion in profits over a three-year period. The bill would also impose a 15% minimum tax on profits earned overseas. The new law would also impose a 1% surcharge on companies buying back stock.

Reduced valuation discounts on qualified small business stock. For high-income-earners, the valuation discount, which is meant to encourage investment in risky businesses at their earliest stages, would be cut. That is, the amount that may be excluded from capital gains from certain qualified small business stock would be reduced.

Retirement Plans

Under Consideration

Contributions to Individual Retirement Accounts (IRA) would be restricted. The new law would prohibit contributions to IRAs if the total value of those exceeds $10 million. The new law would apply to individuals making more than $400,000 and married couples earning more than $450,000.

In addition, for high-income-earners, conversions to Roth IRAs would be prohibited. A Roth conversion is a strategy that moves retirement assets from a traditional IRA to a Roth IRA in order to pay taxes on the gains now instead of later, when tax rates may be higher. The new law could also mandate the distribution of 50% of any amount in an IRA account that exceeds the new $10 million cap.

Build Back Better: Opportunities

The $1 trillion infrastructure bill, which allocates $550 billion to federal spending on roads, bridges, and other infrastructure, is a component of the three-part Build Back Better agenda. The bill calls for spending on a range of projects, including:

- $110 billion for roads and bridges
- $65 billion for high-speed internet
- $66 billion for rail modernization
- $73 billion for the electrical grid
- $55 billion for clean water projects
- $50 billion for other water infrastructure, including drought and flood mitigation
- $7.5 billion for electric vehicle charging stations

Construction. Likely beneficiaries of this spending include companies in the construction industry and those that supply building materials. Companies with long-term contracts to operate infrastructure are also likely to benefit.

High-speed Internet. The $65 billion allocated to high-speed internet is likely to result in opportunities in the areas of e-commerce, 5G networks, cloud computing, and others. These could include companies that invest in data centers and communications towers.

Renewable Energy. Approximately $300 billion would be allocated to tax credits for renewable power, energy efficiency, and biofuels. In addition to clean energy, the credits could increase investments in electricity transmission, power storage, and related manufacturing in the United States.

Electric Vehicles. Tax credits could be expanded for those purchasing electric vehicles, including a bonus for vehicles making use of batteries made in the United States. The legislation also creates a new $4,000 tax credit for the purchase of used electric vehicles.

Housing. $150 billion in new funding could go to the construction and renovation of affordable housing across the country. The bill would also create down payment assistance and subsidized 20-year mortgages for first-time, first-generation home buyers.

Municipal Bonds. In addition to companies that may benefit from the new spending, state and local governments could benefit as well, potentially fueling demand for municipal bonds. The prospect of higher taxes has already been instrumental in driving demand for municipal securities over the past year or more. Although the House bill raises the federal deductibility of state and local taxes from $10,000 to $80,000—likely reducing demand for municipals—higher tax rates are likely to continue supporting the market.

Increased federal spending on infrastructure could reduce the need of state and local governments to issue new debt. This, in turn, could bolster their financial health. They could also use freed-up resources to address underfunded pensions, which have long weighed on issuers in the municipal bond market.

Conclusion

The Build Back Better bill under consideration in the Senate presents both challenges and opportunities for high-net-worth individuals. Given the extensive and complex nature of the changes that are likely to be passed, clients may want to discuss these provisions with their estate planners before they become law. High-net-worth households may also want to consider the investment opportunities that this legislation may create. Acting now will ensure that all available planning options remain open, and that the most appropriate and effective strategies for minimizing tax liabilities and preserving wealth are employed, optimizing the benefit to future generations. ■