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LEGISLATIVE UPDATE: BUILD BACK BETTER

On Nov. 3, 2021, following the Oct. 28, 2021, release of the negotiated Build Back Better plan, the House Rules Committee released additional text around the tax proposals.[1] The tax provisions remain largely unchanged from the Oct. 28 release, but the text provides more insight into the proposed Corporate Profits Minimum Tax.

This Legislative Update adds to our prior commentary and addresses the Corporate Profits Minimum Tax.

REVENUE PRODUCING PROVISIONS INCLUDE, BUT ARE NOT LIMITED TO:

- **15% corporate minimum tax on a qualifying C corporation.** This is a new corporate alternative minimum tax. A qualifying corporation is generally defined as one where, for the applicable three-taxable-year period (beginning for taxable years after Dec. 31, 2019), the corporation reports annual adjusted financial income in excess of $1 billion. As drafted, this will not apply to S corporations, regulated investment companies, or real estate investment trusts.
- **Surtax on qualifying stock buybacks.** This is a new tax that is imposed on a covered corporation, equal to 1% of the fair market value of any stock of the corporation repurchased by the corporation during the taxable year. A "covered corporation" is defined as a domestic corporation whose stock is traded on an established securities market.
- **Additional 5%–8% surtax on high earning individuals and trusts.** For individual (noncorporate) taxpayers with modified adjusted gross income (MAGI) over certain thresholds, there will be an additional surtax. Practically speaking, this creates two additional tax brackets for individuals, trusts, and estates. This would apply to both ordinary income tax rates and long-term capital gains/dividend tax rates.
  - 5% surtax applied to MAGI in excess of:
    - $10 million—Married filing jointly and single filers
    - $5 million—Married filing separately
    - $200,000—Trusts and estates
  - A further 3% surtax applied to MAGI in excess of:
    - $25 million—Married filing jointly or single filers
    - $12.5 million—Married filing separately
    - $500,000—Trusts and estates
- **Net investment income tax (NIIT) expanded definition.** The definition of the 3.8% NIIT surtax is expanded to cover net investment income derived from a trade or business.

[1] Rules Committee Print 117–18 of H.R. 5376 as reported by the Committee on the Budget with Modifications.

- **Modifications to rules relating to retirement plans.** Contributions to "Mega" Roth or traditional retirement accounts are prohibited for qualifying taxpayers (effective date: Dec. 31, 2028). There are new required minimum distributions (RMD) for "Mega" Roth and/or traditional retirement accounts (effective date: Dec. 31, 2028). "Back Door" Roth IRA contributions (effective date: Dec. 31, 2021) are also eliminated. MAGI limitations will be placed on Roth conversions (effective date: Dec. 31, 2031).
- **Investment in tax administration.** Funding will be provided to the Internal Revenue Service to invest in the hiring of enforcement agents, modernizing outdated IRS technology, and taxpayer services. The stated intent is to step up enforcement efforts on wealthy Americans and those with incomes in excess of $400,000 per year.

WHAT ISN'T INCLUDED

- **Changes to the taxation of grantor trusts.** Previous proposals would have unified the income and transfer tax treatment of grantor trusts. To the degree the grantor owned the trust for income tax purposes, they would also own the trust for transfer tax purposes.
- **Changes to how transactions between grantors and their trusts are taxed.** Previous proposals would cause tax recognition of transactions between a grantor and their grantor trust.
- **Limitations on valuation discounts for closely held businesses holding nonbusiness assets.**
- **Reduction in the estate, gift, and generation-skipping transfer tax exemptions.**
- **Capital gains realization at death.**
- **Mark to market realization of capital gains for qualifying taxpayers (generally, billionaires).**
- **Changes to the taxation of life insurance or annuity products.**

THE PROPOSED CORPORATE PROFITS MINIMUM TAX (CPMT) EFFECT ON COLI/BOLI

The proposed CPMT imposes a 15% minimum tax on adjusted financial statement income "book income" for C corporations that have a three-year average of net income over $1 billion. To give you a sense of scale, in 2020 this would have affected 241 of the S&P 500 companies.

Book income includes many items traditionally excluded from calculating taxable income, yet the law as drafted will require significant regulations in order to instruct impacted C corporations on the proper calculation. Given the complexity of the proposed CPMT, and the needed regulatory guidance, the effective date is Jan. 1, 2023.

The language as currently drafted would include the annual growth in corporate owned life insurance and bank owned life insurance (COLI/BOLI) cash values and COLI/BOLI death benefits paid in a given tax year in excess of cash value as "book income" for purposes of calculating the tax. Based upon the time required to implement the proposed tax, we expect that there will be substantial modifications through the regulatory process in 2022 if this legislation is passed.

Like the prior corporate AMT tax, if the CPMT is levied, there would be cumulative credit that would be available to apply against any federal corporate income tax due in future years. In other words, if a company "falls" into the CPMT for a few years, this CPMT is a timing difference or advance payment of future taxes under the normal federal corporate tax.

From the 1980s and ending with the Tax Cuts and Jobs Act, the corporate AMT (then 20%) included annual cash value growth and life insurance death benefits, in excess of cash value, in calculating the AMT base. The prior AMT rules did not have a significant impact on the volume of COLI and BOLI during those years.

NEXT STEPS

The recent reversal on the transfer tax proposals contained in earlier draft legislation could be interpreted to mean that these are currently "off the table." While they still could be incorporated into future proposals, it should provide planners and clients with near-term peace of mind.

Recall that the increases to the estate, gift, and generation-skipping transfer tax exemptions under the Tax Cuts and Jobs Act are temporary. While the newest draft legislation does not cause these increases to sunset in 2022, they will sunset as a matter of law

after Dec. 31, 2025. It is important that our clients who have current or projected estate tax exposure should attempt to plan under the current legal framework. For our clients with a current planning need, the Build Back Better proposals do not pose an obstacle today.

For those who prefer a wait-and-see approach, consider funding a grantor trust with an Applicable Federal Rate (AFR) loan.

- Establish an irrevocable grantor trust. Be sure to include trust provisions that permit a "toggling off" of all grantor trust enabling provisions. The "off switch" must completely disable any provision that could cause the IRS to view the trust as a grantor trust. It is not enough for the grantor to avoid using the power. A trust protector may be added to provide additional flexibility and the potential for nonjudicial trust modification in the future.
- Fund the trust with an AFR loan. A loan to trust will shift client assets into trust without the need to report a gift. A short-term AFR loan (one- to three-year duration) will take advantage of historically low short-term interest rates[2] and provide an option for loan repayment in the near term. Alternatively, use a demand note structure.[3] Unlike a term loan, a demand loan has no fixed repayment date and the interest rate charged is based upon the "blended AFR."[4] The lender retains the right to unilaterally "demand" repayment of the loan principal, which provides clients with control over the timing of repayment. The transfer must be documented and constitute an arm's length, bona fide loan arrangement. Should circumstances change, the grantor may elect to forgive the loan and complete the gift. Alternatively, the grantor may receive repayment of the loan principal in the near term or upon demand.

This approach should provide clients with short-term flexibility in funding and long-term flexibility in trust administration. Critically, this flexibility may cause the client to feel empowered and more comfortable in committing to a proposed estate plan.

NOT THE LAST WORD . . .

The contents of this paper constitute our thoughts and understanding of the tax proposals' impact as of the date of drafting. Given the uncertainty around whether the tax proposals will be passed as drafted, and in what form, as well as their potential application if passed, these positions are subject to change. Both the M Government Affairs Committee and M Financial will continue to monitor the status of these proposals and analyze the impact to our clients and the broader planning community.

[2] For the month of Nov. 2021, the short-term AFR is 0.22%; Rev. Rul. 2021-21 (irs.gov).

[3] If the trust owns a life insurance policy on the life of the grantor/lender, a demand note may not be appropriate as it could risk estate tax inclusion under IRC Sec. 2042.

[4] The blended annual rates are published in the Internal Revenue Bulletin every July.

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