President Biden's Individual Tax Changes Announced in Fiscal Year 2022 Budget Plan

The Treasury Department recently released a General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals (the "Green Book") containing significant modifications to corporate and individual taxation. In this Client Alert, we share our first impressions of the individual tax proposals in the Green Book, which includes new tax changes and adds further details to various proposals in the President's Made in America tax plan ("Biden's Tax Plan"). For previous coverage of President Biden's corporate tax changes announced in Fiscal Year 2022 Budget Plan see here, and for previous coverage of Biden's Tax Plan see here. At this point, it remains highly uncertain which, if any of the Green Book proposals will eventually be enacted into law and in what form, as Congress will be the ultimate drafter of any new legislation. The more noteworthy individual tax proposals in the Green Book are:

Top Individual Income Tax Rate Increase to 39.6 percent

The proposal would increase the top marginal individual income tax rate from its current level of 37 percent to 39.6 percent. The proposal would be effective for taxable years beginning after December 31, 2021.

Tax Long-Term Capital Gains and Qualified Dividends at Ordinary Rates for High Earners

Currently, most realized long-term capital gains and qualified dividends are taxed at graduated rates under the individual income tax, with 20 percent generally being the highest rate (23.8 percent including the net investment income tax, if applicable, based on the taxpayer's modified adjusted gross income). The Green Book proposes that long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million would be taxed at ordinary income tax rates, with 39.6 percent generally being the highest rate (43.4 percent including the net investment income tax ("NIIT")), but only to the extent that the taxpayer's income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022.

This proposal would be effective for gains required to be recognized after the date of announcement (understood to be April 28, 2021, the date when President Biden announced the proposal as part of the American Families Plan).

New Realization Events for Gifts, at Death and for Certain Trusts, Partnerships or Other Non-Corporate Entities

Currently, when a donor gives an appreciated asset to a donee during the donor's life, there is no realization of capital gain by the donor at the time of the gift, and there is no recognition of capital gain (or loss) by the donee until the donee later disposes of that asset. Similarly, when an appreciated asset is held by a decedent at death, generally, the basis of the asset for the decedent's heir is adjusted (usually "stepped up") to the fair market value of the asset at the date of the decedent's death. Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer.

The proposal also provides that gain on unrealized appreciation could be recognized by a noncorporate entity, e.g., a trust, the owner of property, if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.

In addition, the proposal states that transfers of property into, and distributions in kind from, a trust, partnership, or other non-corporate entity, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be realization events. While the proposal appears to target only donative transfers, the language of the proposal is very broad and may cover such basic tax free transactions as contributions and distributions from partnerships and others.

Eliminate Gap in Medicare Taxes for High Earners

Under current law, individuals with income greater than $200,000 (or $250,000, in the case of a joint return) are subject to a 3.8 percent tax on NIIT (generally, passive income). NIIT does not apply to self-employment earnings. Instead, self-employment earnings and wages are subject to employment taxes under either the Self-Employment Contributions Act ("SECA") or the Federal Insurance Contributions Act ("FICA"). These taxes are generally used to fund Medicare are often referred to as "Medicare taxes."

Limited partners and S corporation shareholders who are treated as materially participating in a trade or business are currently not subject to Medicare taxes on their distributive share of business income (for example, a limited partner is subject to Medicare taxes only to the extent the partner receives guaranteed payments for services he provides to, or on behalf of, the partnership). The Green Book's proposal would subject the distributive share of materially participating high-income limited partners to Medicare tax. Similar rules are included for materially participating LLC members and S corporation owners.

Tax Profits from Carried Interest as Ordinary Income

Currently, where partners receive partnership interests, typically interests in future partnership profits referred to as "profits interests" or "carried interests," in exchange for services, such partners' share of profits from the partnership is being determined by reference to the character of the profits in the hands of the partnership. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain.

The Green Book's proposal would generally tax carried (profits) interest income as ordinary income subject to self-employment tax for taxpayers whose income (from all sources) exceeds $400,000, effective for taxable years beginning after December 31, 2021. The Green Book's proposal would apply to a partner's share of income on an investment services partnership interest ("ISPI"). An ISPI is defined as a partnership (i) substantially all of the assets of which are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets) and (ii) over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business. In other words, more than 50 percent of the contributed capital is from passive investors.

Generally, gain on the sale of an ISPI would be taxed as ordinary income. However, the Green Book's proposal suggests that Congress may develop a mechanism to treat gain attributable to goodwill (or otherwise unrelated to the services of the ISPI holder) as capital gain.

Finally, the Green Book's proposal provides for an anti-abuse rule according to which any income or gain from certain "disqualified interests" (such as convertible or contingent debt, options, derivatives) in any entity for which a taxpayer performs services would be taxed as ordinary income.

For more information about Curtis, please visit www.curtis.com.

Attorney advertising. The material contained in this Client Alert is only a general review of the subjects covered and does not constitute legal advice. No legal or business decision should be based on its contents.

Please feel free to contact any of the persons listed below if you have any questions on this important development:

Klas Holm
Partner, Global Tax Co-Chair
kholm@curtis.com
New York: +1 212 696 8800

Eduardo A. Cukier
Partner
ecukier@curtis.com
New York: +1 212 696 6107

Olga R. Beloded
Partner
obeloded@curtis.com
New York: +1 212 697 1559

Marco A. Blanco
Partner, Global Tax Co-Chair,
Geneva Managing Partner
mblanco@curtis.com
New York: +1 212 696 6128
Geneva: +41 22 718 3518
Paris: +1 917 368 8828