Selected Tax Provisions of House Bill No. 5376 – and Economic Implications

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Overview

On November 19, the U.S. House of Representatives passed H.R. 5376, the "Build Back Better Act," on a 220-213 vote. The legislation is a multi-trillion-dollar tax and spend package that was supported by all Democrats except one and no Republicans. The massive bill contains numerous tax-related provisions. Fortunately, it contains neither the proposed reduction to the federal estate and gift tax exemption nor the modification to the current "stepped-up" basis rule at death. But, the bill still proposes to spend several trillion dollars on social programs which has implications for the economy.

Now the bill goes to the Senate where, most certainly, changes will be made – if the bill passes.

Selected tax-related provisions in H.R. 5376 and economic implications – it's the topic of today's post.

Provisions Not Included

Modifications were made to the bill before passage by the House. Numerous tax provisions that had been approved by the House Ways and Means Committee did not make it into the final bill that passed the House. The following is a list of the most significant tax-related provisions that did *not* make the cut:

- An increase in the corporate tax rate to 26.5 percent (the 21 percent corporate rate remains the law);
- Modification to the stepped-up basis rule at death (the rule that property included in a decedent's estate at death receives an income tax basis in the hands of the heir equal to the property's fair market value is retained);
- An increase in the top individual rate to 39.6 percent;
- An increase in the top capital gain rate to 25 percent;
- A limitation on the qualified business income deduction (I.R.C. 199A) for higher income eligible taxpayers;
- An acceleration in the reduction of the federal estate and gift tax exemption equivalent in the unified credit (the "sunset" of the existing federal estate and gift tax exemption remains the law through 2025 and will be $12.06 million per person for deaths occurring and gifts made in 2022).
- A change in the grantor trust rules (death benefits for grantor irrevocable life insurance trusts (ILITs) with future premiums due and death benefits for newly created grantor ILITs are not subject to federal estate tax).
- A change in the annual present interest gift tax exclusion (the current rules for the present interest annual exclusion remain the law with the annual exclusion being $16,000/donee in 2022).
- An increase in the top federal estate tax rate (the current top rate of 40 percent remains the law);
- Valuation rules for certain transfers of nonbusiness (passive) assets and passive interests in entities;
- An increase in the maximum value reduction of real estate for purposes of special use valuation.

Provisions Included in H.R. 5376

Individual Provisions

- Amounts received as paid leave that is provided under the Social Security Act is excluded from gross income. *130004 creating new I.R.C. §139J. Effective upon enactment.*

- Increases and caps the state and local tax deduction at $80,000 (MFJ) or $40,000 (MFS; estate or trust). *137601, amending I.R.C. §164. Effective for tax years beginning after December 31, 2020 and before 2031.* For 2031, the cap would be $10,000. Then there would be no cap for later years.

- Modifies the child tax credit and advance payment rules.

- IRS can recapture upon the Secretary determining a child was taken into account when determining the annual advance amount due to fraud or intentional disregard of the applicable rules. On a joint return, advance payments are treated as being made one-half to each spouse.

- Extended through 2022 the following:
  - Full refundability for taxpayers with a principal place of abode in the U.S. for more than one-half of the year;
  - Increase in age limit of qualifying child to those not having reached age 18;
  - Increase in the amount of the credit to $3,000 and $3,600 for a qualifying child not having reached age 6;
  - The phaseout range beginning at $150,000 (MFJ and surviving spouse); $112,500 (HoH); $75,000 (all others).

- *Effective for tax years beginning and payments made after December 31, 2020, except that the 2021 ARPA expansions for 2022 are effective for tax years beginning and payments made after December 31, 2021.*

- The child tax credit is made refundable for tax years beginning after 2022 with no provision for advance payments after 2022. *137103, modifying I.R.C. §24. Effective for tax years beginning after December 31, 2022.*

- Extends through 2022 the reduction in the age to claim the Earned Income Tax Credit (EITC) from 25 to 19 (except for certain full-time students) and eliminates the upper age limit for the childless EITC. A taxpayer may also use their prior year earned income for EITC computational purposes if earned income in current year is less. *137201, modifying I.R.C. §32. Effective for tax years beginning after December 31, 2021.*

- Allows Pell Grants that are not used for qualified tuition and related expenses to be excluded from gross income, and the amount of the American Opportunity Tax Credit or Lifetime Learning Credit is not reduced by any Pell Grant amount. *137502, modifying I.R.C. §117. Effective for tax years beginning after December 31, 2021.*

- Imposes a tax equal to the sum of 5 percent of a taxpayer's MAGI exceeding $10 million (MFJ) or $5 million (MFS), plus 3 percent of such taxpayer's MAGI exceeding $25 million ($12.5 million for MFS). For purposes of this provision, MAGI is defined as AGI less any deduction allowed for investment interest (as defined by I.R.C. 163(d)) and business interest (as defined by I.R.C. §163(j). *Sec. 138203, creating I.R.C. §1A.*

- Extends through 2025 the eligibility for the Premium Assistance Tax Credit to individuals and families with household income above 400 percent of the Federal Poverty Level. In addition, the provision extends through 2025 the repeal of indexing of the individual or household's share of premiums used in determining the premium assistance credit. *137301, amending I.R.C. §36B. Effective for tax years beginning after December 31, 2021.*

- Excludes from MAGI any portion of a lump-sum payment of Social Security benefits received during the tax year that is attributable to months ending before the beginning of the tax year, for purposes of determining household income with respect to the premium assistance credit. *137303, amending I.R.C. §36B. Effective for tax years beginning after December 31, 2021.*

- Excludes certain dependent income from household income for purposes of determining eligibility for and the amount of the premium tax credit. *137307, amending I.R.C. §36B. Effective for tax years beginning after December 31, 2022.*

Business Provisions

- A provision limiting the deduction of business interest expense to apply the limitation at the partner (or S corporation shareholder) level rather than the entity level such that the small business exemption of I.R.C. 163(j) would not apply with respect to a partner's (or shareholder's) allocable share of business interest expense or other items from a partnership that fails to meet the gross receipts test to qualify as a small business. Disallowed business interest expense under the provision could be carried forward indefinitely. *Sec, 138111, amending I.R.C. §163. Effective for tax years beginning after December 31, 2021, with a transition rule.*

- Expands the net investment income tax (NIIT) created under Obamacare to apply to trade or business income for taxpayers with taxable income exceeding $400,000 (single filer) or $500,000 (MFJ). The provision also applies the NIIT to trade or business income of trusts and estates. However, the

provision does not apply the NIIT to wages on which FICA is already imposed. *138201, amending I.R.C. §1411. Effective for tax years beginning after December 31, 2021.*

- Permanently disallows excess business losses for noncorporate taxpayers. Disallowed losses can be carried forward to the next tax year. *138202, amending I.R.C. §461. Effective for tax years beginning after December 31, 2020.*

- Reinstates the corporate alternative minimum tax (AMT) by imposing a 15 percent minimum tax on corporations with adjusted financial statement income (AFSI) exceeding $1 billion. A corporation's minimum tax equals the amount by which the tentative minimum tax exceeds the corporation's regular tax for the year. Tentative minimum tax is determined by applying a 15 percent tax rate to the corporation's AFSI for the tax year. AFSI is the corporation's net income or loss stated on the corporation's applicable financial statement (with certain modifications) – generally the corporation's Form 10-K filed with the SEC, an audited financial statement or other similar financial statement. 138101, adding I.R.C. §56A. *Effective for tax years beginning after December 31, 2022.*

- Provides that the outstanding debt on direct farm loans to "socially disadvantaged" and "economically distressed" direct farm loan borrowers is not income. No deduction is to be denied, no tax attribute reduced, and no basis increase denied by reason of the exclusion from gross income. *135402. Effective upon enactment.*

- Specifies that a distributing corporation in a divisive reorganization has gain to the extent of debt securities of the control corporation that are transferred to the creditors of the distributing corporation in excess of basis in the assets that are transferred from the distributing corporation to the controlled corporation. Any gain triggered is reduced by any amounts paid by the controlled corporation to the distributing corporation. S *138143, amending I.R.C. §361. Effective for reorganizations occurring on or after date of enactment.*

- For taxpayers with AGI of $400,000 or more, the 75 percent and 100 percent exclusion rates applicable to gains realized from certain qualified small business stock is inapplicable. The 50 percent exclusion of I.R.C. 1202(a)(1) remains available. *Sec. 138149, amending I.R.C. §1202. Effective for sales and exchanges after September 13, 2021, subject to a binding contract exception.*

- Provides for a temporary increase in the employer-provided childcare credit for years beginning after December 31, 2021, and before January 1, 2026. The amount of childcare expenses eligible for the credit is increased from 25 percent to 50 percent. The maximum credit allowed for a year is increased to $500,000. *138515, amending I.R.C. §45F. Effective December 31, 2021.*

Energy Provisions

- Extends through 2026 the existing credit for electricity produced from certain renewable resources. The provision also applies the extension to electricity produced from solar energy which had expired at the end of 2005. The provision also extends for five years the election to claim an investment tax credit in lieu of the production tax credit. 136101, amending I.R.C. §45. *Effective for facilities placed in service after December 31, 2021.*

- Extends the biodiesel and renewable diesel tax incentives; the alternative fuel credit and related payment provision; and the alternative fuel mixture credit through 2026. *136201, modifying I.R.C. §40.*

- Extends the residential energy efficient property credit through 2033 and modifies the phaseout rules. "Qualified battery storage technology" is added to the list of expenditures eligible for the credit. *136302, amending I.R.C. §25D. Effective for expenditures incurred after December 21, 2021.*

- Modifies the energy efficient commercial buildings deduction such that a building must only increase its efficiency relative to a reference building to be eligible for the deduction from 50 percent to 25 percent. The maximum deduction is also modified, and an alternative deduction for energy efficient retrofit property is provided. *136303, amending I.R.C. §179D. Effective for tax years beginning after December 31, 2021.*

- Extends through December 31, 2031, the credit for new energy efficient homes, and changes the existing credit to a $2,500 credit for new home meeting certain energy efficiency standards, and a $5,000 credit for certified zero-energy ready homes. *136304, amending I.R.C. §45L. Effective for dwelling units acquired after December 31, 2021.*

IRA Provisions

- A provision that limits annual contributions to a traditional or a Roth IRA for individuals with combined IRA and defined contribution account balances exceeding $10 million applicable in years in which the cap is exceeded and adjusted taxable income exceeds $400,000 (single and MFS); $450,000 (MFJ); $425,000 (HoH). The provision does not bar rollovers and does not apply to accounts obtained due to death, divorce or separation. Also, contributions to Simple IRAs, SEPs, employer-sponsored defined contribution plans or nonqualified deferred compensation plans are not restricted. *Sec. 138301, adding I.R.C. 409B. Effective for taxable and plan years beginning after December 31, 2021.*

- A requirement that individuals with combined IRA and defined contribution plan accounts (including employee-owned stock ownership plans but with a special rule for ESOPs holding securities that aren't traded on an established securities market) exceeding $10 million take distributions equal to 50 percent of the amount exceeding $10 million in the year immediately following the year the $10 million cap is exceeded. The provision applies to individuals with adjusted taxable income in excess of $400,000

(single and MFS); $450,000 (MFJ) and $425,000 (HoH). *138302, amending I.R.C. 4974. Effective for plan years beginning after December 31, 2021.*

Note: Required distributions from Roth accounts triggered by the cap would not be taxable even for persons not attaining age 59½ or for those who had not had the account at least five years.

· A provision that bars taxpayers from converting tax-deferred, employer-sponsored plan accounts and traditional IRAs to Roth accounts by paying income tax on the current balance to receive tax-free future growth. The provision applies to individuals with adjusted taxable income in excess of $400,000 (single and MFS); $450,000 (MFJ) and $425,000 (HoH). *Sec. 138311, amending I.R.C. §408A(e). Effective for distributions, transfers, and contributions made in taxable years beginning after December 31, 2031.*

Other Provisions

H.R. 5376 also contains many other provisions, including programs to provide up to six semesters of free community college *(Sec. 20021);* free childcare for children under age six and free universal pre-school services *(Sec. 23002),* and; health benefits for eligible individuals wo reside in states that have not expanded Medicaid *(Sec. 30701).* The bill would also expand Medicare to cover dental, hearing and vision care *(Sec. 30901),* and provide up to 12 weeks of paid family and medical leave *(Sec. 13001).* The bill also repeals the oil and gas program for the non-wilderness portion of the Arctic National Wildlife Refuge, and cancels all associated leases. *(Sec. 70804).* Likewise, the bill imposes a "permanent" moratorium on offshore oil and gas leasing in the Eastern Gulf of Mexico, Atlantic and Pacific federal waters. *Id.*

Also, the bill creates a payroll tax credit on up to $12,500 of wages paid during any calendar quarter to "local news journalists" by local newspapers or broadcast stations through 2025. *Sec. 138517.*

Senate Passage?

The Congressional Budget Office estimates that the bill will result in a net increase in the on-budget deficit totaling $389.2 billion over the next 10 years. This figure does not account for any additional revenue that may be generated by additional IRS funding directed toward tax enforcement over the next decade.

Will the bill pass the Senate? That's likely up to Sen. Manchin of West Virginia and Sen. Sinema of Arizona. Sen. Manchin has expressed concern about the cost of the legislation, while Sen. Sinema has publicly expressed her worries about the tax increases.

Then, there are also the problems with the economy at the present time. A University of Michigan Consumer Sentiment Survey indicates that consumer optimism about the economy has plunged to a new low. Complaints about falling living standards have quintupled since January of 2021. http://www.sca.isr.umich.edu/ Third quarter 2021 new home sales collapsed – an annualized quarterly drop of 12.6 percent. Also, the third quarter of 2021 showed the worst-ever 12-month, quarterly and monthly real merchandise trade deficit. Also, payrolls continue to be well short of economic recovery levels.

Perhaps most concerning is that October 2021 consumer inflation jumped to a four-decade high, with year-to-year consumer price inflation at a 31-year high of 6.2 percent. The money supply growth has been astronomical over the past 18 months – up 101.3 percent from February 2020. The inflation has been fueled by the massive spending by the Congress over the past 20 months. There simply is too much money in the economy. It's not just a transitory supply chain problem.

In addition, other factors are responsible for the present inflation in the economy:

- The administration has engaged in policies that have increased the price of fossil fuels which means that the cost of production and transportation have risen. This increases the prices of all goods (price inflation).

- To encourage workers to re-enter the work force (after being paid by public tax dollars to stay at home), employers have raised wages (wage inflation).

- The federal government over the past two years has spent $6 trillion more than it has received in tax revenue (deficit spending). This creates excess demand that adds to inflation.

- The Federal Reserve is not doing anything to stop inflation by increasing interest rates to reduce demand in the economy. There simply is no reason to keep interest rates at near-zero levels which increases demand and further fuels inflation. Unfortunately, Paul Volcker is no longer the Chairman of the Federal Reserve.

Will this economic data matter to the Senate? It should matter before uncorking another multi-trillion dollar bill. In a capital-intensive economy such as the U.S. economy, more capital needs to be created. Unfortunately, H.R. 5376 would not lead to more capital formation, especially because of the increased tax rates on high income earners. That will lead to slower growth rates. The long-term inflationary factors are already present in the economy. Does the Senate understand? The real question is whether Sen. Manchin and/or Sen. Sinema do.

Conclusion

H.R. 5376 as passed by the House is not nearly as bad a bill as initially proposed. However, it is loaded with additional spending that will further harm the economy. The “ball” is now in the Senate’s “court.”

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