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Proposed Federal Tax Legislation Would Reduce QSBS Benefit and Raise Capital Gain Rates

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Last week, the House Ways and Means Committee announced its consideration of federal tax legislative proposals that include reducing the exclusion from income of gain on the sale of qualified small business stock (QSBS) and increasing the tax rate on long-term capital gains, in each case for noncorporate upper-income taxpayers.

Section 1202 of the Internal Revenue Code of 1986 (the Code) provides an exclusion from income for noncorporate taxpayers on gain from sales of QSBS held for more than five years. Section 138150 of the draft legislation would eliminate the 75% and 100% gain exclusions for taxpayers with adjusted gross income of $400,000 or more, limiting such taxpayers to the 50% gain exclusion that currently applies to QSBS issued before February 18, 2009. These changes would increase the top effective rate – inclusive of alternative minimum tax, if applicable – on eligible gain from the sale of QSBS from 0% (for QSBS acquired after September 27, 2010) or 9.42% (for QSBS acquired after February 17, 2009, and before September 27, 2010) to 16.88% (without taking into account the proposed 3% surcharge discussed below).

Section 138202 of the draft legislation would increase the top long-term capital gains rates from 20% under current law to 25% (increased in each case by the 3.8% tax on net investment income). Furthermore, Section 138206 of the draft legislation would impose a tax of 3% on modified adjusted gross income in excess of $5 million ($2.5 million for married individuals filing separately and $100,000 for estates and trusts), which could increase the rate on long-term capital gains to as high as 31.8%.

Some of these provisions, if enacted, would have effective dates retroactive to the date the legislation was proposed – September 13, 2021. An exception to this retroactive effective date applies to written binding contracts in effect as of September 12, 2021 (in the case of the 50% limit on the gain exclusion for QSBS) or September 13, 2021 (in the case of the increase in the long-term capital gains rate), provided that the contract is not modified thereafter in any material respect. Consequently, taxpayers should exercise caution when considering amendments to contracts that were entered into on or before September 13, 2021, if they expect to take advantage of the current exclusion applicable to gain from QSBS or the current long-term capital gain rates.

Other notable proposed changes to domestic taxation in the draft legislation include:

- Increasing the maximum corporate income tax rate to 26.5% from the current flat rate of 21% (Section 138101).
- Increasing the top marginal rate on individual income from 37% to 39.6% (Section 138201).
- Addressing calls for “carried interest” tax reform, generally increasing from three years to five years the holding period required for gain attributable to an “applicable partnership interest” to qualify for long-term capital gain treatment, delaying the start date for that holding period until a fund has invested “substantially all” of its committed capital, and extending this provision to all assets eligible for long-term capital gain rates, including Code Section 1231 gain (Section 138149).
- Expanding the 3.8% tax on net investment income to include pass-through business income of “active” S corporation shareholders and “limited partners” whose modified adjusted gross income exceeds $400,000 for single filers or $500,000 for joint filers (Section 138203).
- Capping the deduction for qualified business income under Code Section 199A (Section 138204).
- Making permanent the Code Section 461(l) disallowance of “excess business losses” (Section 138205).
- Expanding the withholding tax obligations for US borrowers paying interest to non-US lenders that own 10% or more of either the voting power or value of the stock of such borrowers (Section 138145).
- Permitting any corporation that was an S corporation on May 13, 1996, and at all times thereafter, to reorganize as a partnership on a tax-free basis during the two-year period beginning on December 31, 2021 (Section 138509).

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