Financial Alternatives
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Planning Newsletter **October 2021**

Tax Increases: Most Will Not Be Affected

More detailed proposed tax changes have been released from the Biden tax plan. Will they affect you? Are you concerned about your taxes going up? Before we get into it, just a quiet mention that this newsletter should not be construed as tax or financial advice specific to any one individual. These statements are general in nature; for advice pertinent to your specific situation, you should consult with a tax advisor.

If you are married and filing jointly ("MFJ") with a taxable income of $450,000 or less or if you are single ("S") with a taxable income of $400,000 or less, you can relax because you will not be affected much at all.

In fact, you may benefit from some of the proposed changes such as the return of the state and local tax deduction or a proposed increase in the 401 (k) makeup contributions for those over age 50 from $6,500 to $10,000.

For those of you with income above $400,000 S and $450,000 MFJ the rest of this newsletter will be particularly relevant.

Executive Summary

- Single taxpayers with taxable income less than $400,000 and married filing jointly (MFJ) taxpayers with taxable income less than $450,000 should not see much change in the taxes they pay as a result of the changes under the new Biden tax plan.
- Some taxpayers with income below $400,000 and $450,000 could see tax reductions due to the return of the state and local tax deduction.
- If your income is above this $400,000 and $450,000, expect your taxes to go up.
- Top marginal tax rates may go back to 39.6%.
- Back door Roth IRA conversions may no longer be available.
- Capital gains tax rates may increase to 25% beginning at $450k MFJ instead of currently being 20% starting at $501k MFJ.
- Corporate taxes rates instead of being a flat 21% would be 18% on income less than $400k, 21% on income of up to $5M and 26.5% for income over $5M
- Estate tax exemptions could fall to $5,800,000 from $11,700,000.

In this world nothing can be said to be certain, except death and taxes – Benjamin Franklin

Some Proposed Changes

If your taxable income is about $400,000 S and $450,000 MFJ, expect your taxes to go up. But again, we could see a partial return of the state and local tax deduction that would help offset this increase depending on how much over the $400,000 and $450,000 your income is, combined with how much state income tax and property tax you pay.

Repealing the $10,000 cap on state and local tax (SALT) deductions would primarily benefit high-earning taxpayers in high tax states like California, New York, New Jersey and Connecticut. In 2022, repealing the SALT cap under current law would provide a 2.8% increase in after-tax income for the top 1 percent of taxpayers and a 1.2% increase for the next 4 percent of highest-earning tax payers.

Below are some of the basic proposed changes:

- Top marginal tax rate increased to 39.6% beginning at $400k S and $450k MFJ. The current top rate of 37% begins at $628K MFJ (effective 2022).
- Capital gains tax rates increased to 25% beginning at $450k MFJ instead of currently being 20% starting at $501k MFJ (effective now).
- Net Investment Income Tax (NIIT): S Corporation profits would no longer be free from employment taxes and NIIT, a 3.8% tax would be imposed on all pass-through business earnings either through the Medicare tax or through NIIT (effective 2022).
- Income, including capital gains and business income over $5M and $100,000 for trusts would be subject to a new 3% surcharge (effective 2022).
- Corporate taxes rates, instead of being a flat 21%, would be 18% on income less than $400k, 21% on income of up to $5M and 26.5% for income over $5M (effective 2022).
- Some private placement investments invested in your IRA would be eliminated (effective

2022 with two years to remove from existing IRAs). This could affect the First Trust Deed investment we have in some client's IRAs. We are monitoring this development closely, and will be in touch with clients if and when there are material changes that need to be considered as a result of these new guidelines.

- Back door Roth IRA conversions no longer available (effective 2022). If this is something you are considering, your last chance to do this would be anytime between now and the end of 2021.
- Roth conversions would no longer be available for clients with income over $400k S, $450K MFJ (effective 2031). Plan for conversions over 10 years if 25% tax bracket or lower.
- After tax 401(k) contributions and conversions will no longer be available (effective 2022). You need to make sure your companies are converting before the end of the year.
- The estate tax lifetime exemption currently at $11,700,000 per person will be reduced to $5,800,000. The reduction for real estate used in a family business will be increased to $11,700,000 (effective 2022).
- Valuation discounts for non-business assets such as investment assets in family limited partnerships will be eliminated (effective with transfers of gifts after enactment).
- Grantor trusts such as SLATs, IDGTs and basically any trust in which the income passes to the grantor would be included in the estate for estate tax purposes. This is effective with new trusts signed after enactment and with new gifts or funds transferred after enactment.

A Few Thoughts and Ideas

For those with income above $400k S and $450k MFJ the biggest change in our opinion will be the increase to 39.6% on income above this amount. If you are in this situation and it looks like your income will stay at this level all the way through your retirement years, you may want to consider doing a Roth conversion this year because you would be paying a 37% tax rate on the converted amount.

Another way to increase income - at the lower 2021 rates - may be to postpone a business investment until 2022 when the write off can be taken while you are in a higher tax bracket. This would create more income in 2021 while you still have the 37% bracket. Income would be reduced by the business expense in 2022 when tax rates are higher, at 39.6%.

If on the other hand, you will fall below the $400k S and $450k MFJ when you retire and begin withdrawing from your retirement funds, there would be no need to accelerate income into this year and pay at the 37% rate. Each person and household should look at their individual circumstances to determine the best course of action.

As tax rates increase, tax efficient investing becomes even more important. We will continue to focus on low cost, low turnover investments that minimize capital gain distributions, which results in more tax efficient growth. We will also continue to proactively harvest any losses through tax swaps during market corrections so these losses can be used to offset future capital gains.

When tax laws change some people can get emotional and forget that they should never let taxes be the main reason to buy or sell their investment holdings. The primary criteria should be the value of the investment itself as it relates to your goals.

Should you Make Family Gifts Now?

Giving large amounts to family members is a very complicated and personal question - what is right for one family, may be wrong for another. That stated, we'd like to share some general thoughts on the matter. If you are single, have a $5,000,000 estate, and are living comfortably within your means, you are unlikely to have an estate tax problem because if the new estate tax lifetime exemption becomes law, you will be able to pass your estate on to your heir's estate tax free. You can also give up to $15,000 per person each year and not use up any of your $5,800,000 exemption. So, you do not need to consider family gifts to reduce the size of your estate.

The same goes for a married couple except the amounts would double - they could pass an estate of up to $11,600,000 estate tax free, and gift a combined $30,000 each year to any person.

But now let's consider a married couple with an estate valued at $23,400,000 with the following circumstances: 1. they are in their mid-80's, 2. they can easily maintain their lifestyle with an estate of $10,000,000, they have two very responsible kids who are also both financially responsible, and many grandkids.

If this couple died today with the current estate tax law, they would pass their estate onto their children and pay zero estate tax because they each have a $11,700,000

exemption. If they die after the proposed law takes effect and the exemption is reduced to $5,800,000, they will have an estate tax of roughly $4,720,000 to pay.

To reduce this $4,720,000 tax, one of the spouses could give the kids $11,700,000 and use up their entire $11,700,000 exemption before it drops to $5,800,000. The other spouse would still have the lower $5,800,000 exemption amount, and if they both died next year after doing this planning, they would have reduced their estate tax by roughly $2,360,000.

The top estate tax rate is 40%. If the taxable portion of one's estate is less than $1,000,000, the rate would be less than 40% but just thinking of the estate tax as being 40% will give you a very close approximation of what it will be. For example, on a taxable estate of $2,000,000, ($2M x 40% = $800k) you would pay about $800,000 in estate taxes. So, if you are able to use up to $5,900,000 of estate tax exemption before it drops to $5,800,000, you basically would save $2,360,000 in estate taxes. In most cases these types of gifts are made to irrevocable trusts with the children listed as beneficiaries.

If a married couple had an estate worth $40,000,000 and they could easily live on $15,000,000, they may want to gift their family $23,400,000 and potentially save $4,720,000 in estate taxes. On the other hand, they may not want to give up control of their estate. They may feel like their kids are going to get enough money regardless, or they may have other charitable desires that will help them to minimize any future estate tax.

There is no right answer here. In our opinion, what is most important is for each family or individual to really understand all the moving parts and to make an educated, informed and wise decision that they feel is in the best interest of all parties involved.

There is still time to make gifts to take advantage of the higher existing estate exemption, but you'll need to move quickly because the work will need to be done before the end of the year if the existing tax proposal passes.

Summary

Tax laws are shifting once again, but not much will change for individuals with income under $400k and couples with income under $450k. If your income is higher than this, consider moving income into tax year 2021 to take advantage of the top 37% tax bracket and consider putting expenses off until next year when you will be in a 39.6% tax bracket.

Continue to do all you can to keep your investing as tax efficient as possible. Discuss any Roth IRA strategies that may pertain to you with your advisors.

If you have a large taxable estate and are contemplating making family gifts to use up the entire $11,700,000 exemption, move quickly to consult with your advisors in an effort to come to a measured, wise decision.

If you have any questions on anything in this newsletter, give us a call and we'll be happy to discuss it with you. We hope you are enjoying the beginning of fall and we are wishing you all the best.

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Source: https://taxfoundation.org/salt-deduction-cap-repeal/

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