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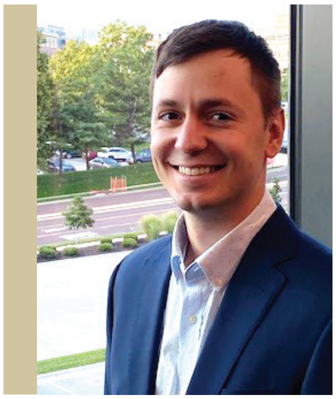
2021 TAX LEGISLATION UPDATE

What's Passed, What's Proposed, What's Important to Know



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With the extended 2020 tax filing deadlines upon us, conversations around proposed 2021 tax legislation are returning to the forefront. As many expected, President Biden is targeting tax reform as aggressively as President Trump did in 2017.

So, let's begin with what we know and transition into what has been proposed.

The Senate recently passed the Infrastructure Investment and Jobs Act, a $1.2 trillion infrastructure package and a $3.5 trillion budget reconciliation plan which would adequately fund all of President Biden's major programs. The most significant tax items included in the Act are the termination of the Employee Retention Credit at the end of the third quarter (instead of at the end of calendar year 2021) and stronger tax enforcement on cryptocurrency transactions.

Well, that wasn't very much that's known, was it? I guess the real fun is in talking about what *could* happen! Up next are the proposed changes to tax policy across a variety of areas. The focus of the proposals are clear and synonymous with President Biden's campaign from the start: increase taxation on high-income taxpayers and corporations while expanding credits for the working class.

But with everything that I'm about to cover, it's important to caveat the rest of the article with this statement: It is all still *proposed* legislation and is subject to change or elimination.

On September 13, 2021, the House Ways and Means Committee published an official release of the tax provisions that are currently being considered as the Democrats attempt to fully reconcile the budget. The proposed laws are broken down between corporate and international taxation, individual taxation and retirement plan modifications.

Corporate and International Taxation

Corporate tax reform begins with the introduction of a graduated rate structure to replace the current 21 percent flat rate. The first $400,000 of income would be taxed at 18 percent, 21 percent from $400,001 to $5 million, and 26.5 percent for income exceeding $5 million. The benefit of the graduated rates phases out for corporations making more than $10 million. This is slated to be effective for taxable years after December 31, 2021.

The 75 percent and 100 percent Section 1202 special exclusion rates for qualified small business stock would no longer exist for taxpayers with adjusted gross income of $400,000 or higher. However, the 50 percent exclusion would still be available. This is proposed to be effective as of September 13, 2021.

To help balance the increased corporate tax rates, the proposal also includes the expansion of the Low-Income Housing Tax Credit, makes permanent the New Markets Tax Credit and establishes a new $2 billion tax credit – the Neighborhood Homes Investment Credit – among other changes.

The provisions also encompass international tax law changes that would:

- Limit the interest deduction available to specified domestic corporations based on the individual company's ratio of total earnings as compared to the international financial reporting group.
- Reduce the Section 250 deduction, which functions as a tax neutralization for domestic corporations when sourcing intangible foreign income, for a global minimum tax inclusion based on foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).
- Reduce the foreign-derived intangible income deduction (FDII), which allows U.S. C corporations to claim a deduction based on net foreign-derived income as compared to total net income, from 37.5 percent to 21.875 percent.
- Reduce applicability of Section 245A dividend exemption to only allow 100 percent participant exemption to be applied to dividends received from controlled foreign corporations.
- Provide new general business credits for locating jobs and business activity within the U.S.

Individual Taxation

The following provisions would increase taxation of high-income taxpayers and extend credits for low- to middle-income taxpayers. The proposals generally define high-income taxpayers as married individuals filing jointly with taxable income exceeding $450,000 ($400,000 single and $425,000 head of household). Among the provisions:

Increase the Top Marginal Tax Rate

- The proposal would increase the top marginal tax rate to 39.6 percent from 37 percent on taxable income in excess of $450,000 for married individuals filing jointly ($425,000 for head of household filers, $400,000 unmarried taxpayers, $225,000 for married filing separately and $12,500 for estates and trusts), effective after December 31, 2021.

Surcharge on High Income Individuals, Trusts and Estates

- This would implement a tax of 3 percent of a taxpayer's modified adjusted gross income in excess of $5 million ($2.5 million married filing separately). Modified adjusted gross income for this provision is defined as gross income less any deduction allowed for investment interest. The effective date would be after December 31, 2021.

Increase the Top Capital Gains Rate

- The proposal would increase the top capital gains rate from 20 percent to 25 percent for capital gains occurring after the date of introduction. Currently, taxpayers married filing jointly pay 20 percent on capital gains once taxable income exceeds $501,600 ($473,750 head of household filers, $445,850 single filers).
- For gains recognized after September 13, 2021, but arising from transactions prior to that date, the 20 percent capital gains rate would still be in effect as long as the gain is recognized during the 2021 taxable year and has documentation supporting the transaction date.
- The capital gain proposal included in the House Ways and Means Committee release differs significantly from President Biden's proposal of subjecting capital gains to ordinary income rates if a taxpayer's AGI exceeds $1 million.

Changes to Estate and Gift Taxation

- The Tax Cuts and Jobs Act of 2017 doubled the estate and gift tax exemption to $10 million and was slated to expire at the end of 2025. The proposal moves up the expiration date to December 31, 2021, at which time the exemption would revert to $5 million.
- To offset this change, there is a proposal to increase the special valuation reduction available for qualified real property that is used in a family farm or family business. This would allow decedents who own real property used in a farm or business to value the property for estate tax purposes based on actual use instead of fair market value. The allowable reduction would increase from $750,000 to $11.7 million.
- Under current law, grantor trusts can be used to move assets out of a taxpayer's estate while still maintaining control of the assets. A provision is included to treat grantor trusts as part of a decedent's taxable estate when the decedent is deemed the owner of the trust(s). It also includes a provision to treat sales between the grantor trust and the trust owner as sales between third parties. These changes would apply only to future trusts and to future transfers.
- The House Ways and Means Committee release does not include the previous proposal from President Biden which would eliminate the step-up in basis to fair market value for appreciated assets that change ownership due to either a gift or death.

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Expanding the Net Investment Income Tax (NIIT)

- Under current law, the net investment income tax (3.8 percent) is charged to married taxpayers filing jointly with incomes above $250,000 ($200,000 for unmarried taxpayers).
- The tax is calculated on net investment income which includes interest, dividends, capital gains, passive activities and royalties.
- The proposal would target taxpayers with taxable income in excess of $400,000 (single filer) or $500,000 (joint filer) by enforcing NIIT on net income derived in the ordinary course of a trade or business. This does not include wage income that is already subject to FICA taxes. This would be effective in taxable years after December 31, 2021.

Qualified Business Income Deduction

- The proposal would establish a deduction cap for joint tax filers at $500,000 ($400,000 single, $250,000 for married filing separate, $10,000 for trusts and estates) for tax years after December 31, 2021.

Make *Permanent Excess Business Loss Limitation*

- Under current law, business losses are eligible to offset other types of income for noncorporate taxpayers. However, the losses are limited to $540,000 (married filing jointly) and $262,000 (all other filers) in 2021.
- This law is currently set to sunset on December 31, 2026. However, the proposal would extend this provision permanently.

Proposed Changes to Retirement Plans

IRA Contribution Limits

- There currently aren't any limitations on the balances of Traditional or Roth IRAs. However, legislation is being proposed to prohibit taxpayer contributions to an IRA once the total value of an IRA and defined contribution retirement accounts exceed $10 million as of the end of the previous taxable year. This limit would be imposed on those classified as high-income taxpayers.
- The proposed effective date is after December 31, 2021.

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Increase in Required Minimum Distributions for High-Income Taxpayers

- If an individual's combined traditional IRA, Roth IRA and defined contribution retirement account balances exceed $10 million at the end of a tax year, and the individual is a high-income taxpayer, a minimum distribution would be required the following year *regardless of age*. The distribution would be 50 percent of the taxpayer's combined account values in excess of $10 million.
- Further, if the combined balance in the referenced accounts exceeds $20 million, taxpayers would be required to distribute from Roth accounts the lesser of the amount needed to bring the total account values down to $20 million or the aggregate balance in the Roth accounts.
- If these distributions don't meet the 50 percent rule above, taxpayers would then take the remaining calculated distributions from traditional accounts.

Elimination of Backdoor Roth Contributions

- Currently, there is no income limit prohibiting a taxpayer from converting traditional IRA funds to a Roth IRA (also known as a "backdoor" strategy). The proposed legislation prevents high-income individuals from converting funds to a Roth IRA. This would be effective for taxable years after December 31, 2021.
- This provision also eliminates an employee's ability to make after-tax contributions to qualified plans and prohibits after-tax IRA contributions from being converted to Roth accounts, regardless of income level.

Additional Proposals

The House Ways and Means Committee release also contains several proposals to either make permanent or expand existing credits that are aimed at working families. The following credits would be made permanent:

- Premium Assistance Tax Credit
- Earned Income Tax Credit
- Child and Dependent Care Tax Credit

Additionally, expansion of the Child Tax Credit that previously passed during 2021 would be extended through 2022 and the Childcare Tax Credit for Businesses would be expanded to 50% of the first $1 million of qualified childcare expenses, up from $150,000.

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There is also a provision included to allow for up to $250 in dues to a labor organization to be claimed as an above-the-line deduction against AGI.

Lastly, the release includes provisions to help increase compliance and tax administration. Fortunately, the burdens of the proposed changes (1099 and cryptocurrency reporting requirements) do not fall on the individual taxpayer, but rather the reporting entity.

In Summary

As the proposed changes continue to be fleshed out and debated, discussions surrounding tax legislation will become more prominent. While the timing of the bill is uncertain, I believe we will gain further clarity over the next few weeks.

As your questions arise, Creative Planning has the expertise to listen and provide guidance based on the latest information. Please reach out to your wealth manager if you have any questions about how the proposed tax legislation might affect you.

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