



## WHAT YOU NEED TO KNOW: 2021 DEMOCRAT TAX PROPOSAL

The Democrats’ tax proposal that just came out of the House Ways and Means committee has a number of surprises in it but mostly sticks to a theme of “tax high income earners and the uber-wealthy.” While the proposal is not law, there are some planning issues that would be prudent to consider in case it does become law.

### It’s Back: 39.6% Top Tax Bracket

No real surprise here, but taxes are going up. First, under the proposed plan, the 32% and 35% brackets would be condensed (which means you would be in a higher bracket faster). Adding insult to injury, the 37% tax bracket would be scrapped and the 39.6% tax bracket re-introduced in this bill, starting at \$400k+ for Single filers and \$450k+ for Married Filing Jointly (MFJ), or amounts over \$12.5k for Trusts and Estates.

(We must take a moment to note how profoundly nonsensical this is – a single person making \$399k is fine but a married couple where each earns \$230k is slated for the highest tax rate?)

	Single		Married Filing Jointly	
	Current	Proposed	Current	Proposed
10%	\$0 - \$9,950	\$0 - \$9,950	\$0 - \$19,900	\$0 - \$19,900
12%	\$9,951 - \$40,525	\$9,951 - \$40,525	\$19,901 - \$81,050	\$19,901 - \$81,050
22%	\$40,526 - \$86,375	\$40,526 - \$86,375	\$81,051 - \$172,750	\$81,051 - \$172,750
24%	\$86,376 - \$164,925	\$86,376 - \$164,925	\$172,751 - \$329,850	\$172,751 - \$329,850
32%	\$164,926 - \$209,425	\$164,926 - \$209,425	\$329,851 - \$418,850	\$329,851 - \$418,850
35%	\$209,426 - \$523,600	\$209,426 - \$400,000	\$418,851 - \$628,300	\$418,851 - \$450,000
37%	\$523,601+		\$628,301+	
39.6%		\$400,001+		\$450,001+

Source: Michael Kitces

**Action:** Consider pulling income forward into 2021 if you are a high-income earner who may be affected by these higher tax rates.

This is easier for business owners. Normally, high earners seek to defer paying taxes. In this case, you may want to accelerate your income to pay taxes at a lower rate. Continue to maximize pre-tax savings opportunities. Do not neglect your Health Savings Account.

**Action:** Consider whether certain deductions would be more valuable in 2022. For example, you may wish to defer a charitable donation until 2022.

**Effective Date:** January 1, 2022

### Higher Capital Gain Rates

The proposed bill would increase the highest capital gains tax rate from 20% to 25% for all transactions completed after 9/13/2021 (unless you have a binding contract to sell). This new higher rate kicks in at a lower income level (\$400k Single/\$450k MFJ). And, when you include the 3.8% Medicare Surtax on high earners, the top capital gains rate would rise to 28.8%.

**Action:** If you are selling a business and have a contract to sell, confirm with your tax and legal team if you would qualify for the lower capital gains tax rate.

**Action:** If you are in a high-income tax bracket now and you are considering selling appreciated stock, consider whether or not you will be retiring soon or otherwise find yourself in a lower tax bracket. If so, you may be able to avoid the higher proposed capital gains tax by waiting until your income is lower.

**Disclosure:** There are many important reasons why you may wish to sell and recognize a capital gain even at higher long-term capital gains tax rates. Taxes are only one consideration.

**Effective Date:** September 14, 2021

### Additional 3% Tax on High Income

The Democrats’ tax proposal would impose an additional 3% tax for ultra-high earners, starting at \$5 million of Modified Adjusted Gross Income for both Single filers and MFJ. This would also apply to trusts for any income generated in excess of \$100k.

**Action:** Consider ways to defer income, if possible. For example, if you’re selling a business and it’s a one-time event, is there any way you can defer part of the gains, such as in an installment sale?

**Effective Date:** January 1, 2022

## **Forced RMDs from Super IRAs**

Also included is a provision that would impact Required Minimum Distributions (RMDs) from IRAs with balances over \$10 million for high income households (\$400k Single/\$450k Married Filing Jointly). If someone has an IRA worth between \$10 and \$20 million and their income crosses that threshold, they are now looking at an RMD of 50% of the amount over \$10 million (but below \$20 million).

In other words, if you have a \$15 million IRA and earn \$440,000 as a couple (MFJ) you're OK. However, if you earn \$455,000 as a couple, now you're looking at a \$2.5 million RMD and that really hurts.

This means it's imperative that individuals who own huge IRAs engage in robust tax planning. The cost of not doing the required planning could literally be millions of dollars.

If you have \$20 million (or more) in an IRA and you cross those income thresholds, you would be forced to take an RMD of the lesser of:

- The entire amount over \$20 million
- Or, total balances in all Roth accounts (IRAs, 401(k)s, Inherited Roths, etc.)

After taking that distribution, then you would have to take the 50% RMD of amounts over \$10 million.

*Effective Date: January 1, 2022*

## **Roth IRA Conversions**

Under the proposal, Traditional-to-Roth IRA Conversions will no longer be allowed for taxpayers in the highest bracket beginning January 1, 2032.

*Action: Since this will not be effective for 10 years (if passed), there is still plenty of time to consider converting pre-tax retirement accounts, although it is rare that Roth conversions would make sense for those in the top tax bracket.*

*Effective Date: January 1, 2032*

## **The Backdoor Roth and Mega-Backdoor Roth May Be Dead**

It looks like the end of the road for the "Backdoor" Roth and "Mega-Backdoor" Roth IRA strategies. The proposed bill would no longer allow the conversion of after-tax contributions, effectively killing off these strategies.

*Action: If you have after-tax contributions languishing in an IRA somewhere, you need to figure out whether or not you should convert them now. If the law passes this would mean no more conversions of after-tax IRA money in 2022 and beyond.*

*Action: If you're a high-income solo-preneur with a solo-K you need to get serious about whether or not you can implement a mega backdoor Roth strategy now. Remember, you may have to convert the after-tax money prior to 2022.*

*Effective Date: January 1, 2022*

## **Grantor Trusts and Valuation Discounts**

Grantor trusts are a popular type of estate planning technique that allows an individual to move an asset out of their estate that they anticipate will significantly grow in value. In order to qualify as a Grantor trust the individual who sets up the trust must retain some sort of control over the assets (i.e. they may pay the income taxes on the assets, retain rights to the income or corpus, etc.). Certain types of grantor trusts would be curbed under this law.

If you were considering using an intentionally defective grantor trust (IDGT) or an ILIT (Irrevocable Life Insurance Trust) in your estate plan but haven't gotten around to it, call your estate planning attorney and determine if the strategy makes sense for you. This provision would only apply to new defective grantor trusts—not existing ones—so you still have time to put this strategy in place.

Some individual and business owners have used valuation discounts to reduce the value of gifts they make to their heirs. The bill would provide that "non-economic" discounts would be restricted going forward. This would not apply to actual family-owned businesses or privately held businesses.

*Action: Call your attorney and financial planner. Determine if a grantor trust strategy makes sense for you and take action quickly.*

*Action: Were you thinking of gifting assets after applying a valuation discount to them? If so, the clock is ticking fast. If this bill is passed the end to the valuation discount would be effective at passage.*

## **Estate Tax Exemption**

The proposed bill would reduce an individual's gift and estate tax exemption to about \$6 million starting in 2022 vs. 2021's \$11.7 million per person exemption. Many estate planning advisors are reminding clients that gifts can be made without fear of being clawed back.

The issue really becomes, for those with estates who would be affected by a lower estate tax exemption, how much can you "safely" give away? With a top estate tax rate of 40% it pays to think through this carefully. You don't want to jeopardize your own financial security, but at the same time, the hard dollar costs of not planning for this lower estate tax exemption carefully are high.

*Effective Date: January 1, 2022*

## What's *not* in the bill:

### **No SALT Fix – Yet...**

Originally imposed with the Tax Cuts & Jobs Act (TCJA) in 2017, the State and Local Tax cap limits the amount of state and local income taxes a taxpayer can deduct on their Federal tax return to \$10,000. This provision disproportionately affects people in high property and income tax states. However, many high-income earners all over the country have also been negatively impacted.

For example, Sarah and Brandon are both employed and have a joint household income of \$250,000. In Virginia they would pay a little over \$14,000 in state income taxes. They also own a home valued at \$525,000 and pay \$4,500 a year in local property taxes.

Their total SALT tax liability would be \$18,500. However, only \$10,000 is currently deductible on their Federal return. At a 24% Federal income tax rate the SALT cap costs Sarah and Brandon about \$2,000 a year.

This has long been on the Democrats radar and generally, we would be surprised if a repeal of the SALT cap wasn't included in a final bill.

### **Step-up in Basis**

Under current law, after you die, any property you own gets a step-up in basis. This means that if you own \$200,000 in ABC stock that you bought for \$50,000, you have a \$150,000 capital gain. Assuming you owned ABC stock for at least one year, if you sold ABC stock, you would owe long-term capital gains tax on your gain.

At a 20% long-term capital gains tax rate that would cost you \$30,000 in federal taxes.

However, if you die the stock's basis becomes the price of ABC stock on the date of your death (unless your executor makes an election to have the assets valued 6 months after your death). This means that now your heirs can sell ABC stock without paying any capital gains tax. This saves your heirs \$30,000.

There are several proposals around how this transfer of wealth should be taxed. They range from taxing it all at the date of death, to a carry-over basis proposal, to no change. However, the 2021 Democrat proposal (in its current form) does not address the step-up in basis rule at all.

### IMPORTANT CONSIDERATIONS

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