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Preparing for potential tax law changes

Proposals under consideration in spring 2021 that could affect individuals, business owners, estates and the markets

The Biden administration and others have outlined wide-ranging proposals for legislation that would significantly overhaul current tax laws. It is important to note that all of the potential changes listed here are nothing more than proposals at this stage and have not been passed into law. Yet, it can be crucial to understand how any changes could impact your own financial circumstances.

Who could be affected by these proposed changes?

The proposals on the table cover a wide range of the tax laws, including income tax, FICA (Social Security) tax and estate and gift taxation. Current policies may affect you if you:

- Earn in excess of $400,000 (as a household)
- Itemize deductions on your federal income tax return
- Have IRAs or workplace retirement plan savings
- Make annual gifts to one or more individuals
- Receive annual gifts
- Have an estate that is valued at greater than $3.5 million
- May inherit assets in the future

Here is a look at changes that could occur, depending on how a final package of legislation is structured and whether it wins approval of both houses of Congress and is signed into law by President Biden.

Tax changes that could affect personal income

Raising the top tax rate

The Tax Cut and Jobs Act (TCJA) of 2017 reduced the top marginal income tax rate from 39.6% to 37%. Proposals today would restore the top rate to 39.6%. In 2021, the top marginal tax bracket applies for income above:

- $523,600 for individual tax filers
- $628,300 for married couples filing a joint return
- $314,500 for married couples filing separately
- $523,600 for those filing using head of household status

However, under current proposals, households with incomes higher than $400,000 could see their federal income tax liability increase.[1]

[1] Important disclosures provided on page 8.

Itemized deductions

The TCJA imposed a maximum itemized deduction of $10,000 that could be claimed for state and local income or sales taxes and property taxes paid in a given year (often referred to as SALT deductions). That limit would be eliminated under current proposals, restoring the ability to fully claim those deductions.[1]

However, additional proposals could limit the ability to claim deductions for those in higher income tax brackets. Itemized deductions could be limited to the 28% tax bracket. Another aspect of the proposed changes would reinstate the so-called Pease Limitations itemized deductions for taxpayers earning more than $400,000.[1] This limitation required some higher income taxpayers to reduce itemized deductions by a certain percentage. If it is reinstated, a number of taxpayers will see their ability to fully utilize itemized deductions limited and their tax liability increase as a result.

FICA (Social Security) taxes

Social Security taxes have two components, Old-Age, Survivors, and Disability Insurance (OASDI) tax at 6.2% and Hospital Insurance Tax at 1.45% for a total tax of 7.65% paid by both the employee and employer. Self-employed individuals pay both halves of the Social Security taxes, OASDI tax at 12.4% and Hospital Insurance Tax at 2.9%. Under current law, the Hospital Insurance Tax applies to everybody earning income, but there is a cap of $142,800 in 2021 on income to which OASDI taxes are applied. All earnings above that amount are currently not subject to OASDI taxes. While President Biden has not included a specific proposal to alter the OASDI tax at this time, he has, in the past, endorsed a specific plan. It would apply an additional 12.4% OASDI tax for income levels above $400,000 (shared by the individual taxpayer and the employer). This is one of many proposals that have been laid out as alternatives by the Social Security Administration to improve the program's long-term solvency.[2]

IRAs and workplace retirement plans

Required minimum distributions (RMDs) from employer-sponsored plans and traditional IRAs currently must begin by April 1 in the year after the year in which an individual reaches age 72. A new proposal would delay the required starting date for IRA or retirement plan distributions as follows[3]

For those who turn age:	RMDs must begin after reaching age
72 after 12/31/2021	73
73 after 12/31/2028	74
74 after 12/31/2031	75

Delayed starting dates for required distributions allow money to continue to grow on a tax-advantaged basis in retirement accounts for an extended period of time.

An additional provision of the same proposal would expand the amount that individuals age 62 and older could contribute to their workplace retirement plan compared to current law. This would allow more income to be deferred from current taxation.

Tax changes that could affect investments

Long-term capital gains and qualified dividends

Under current tax law, individuals pay a federal income tax rate ranging from 0% to 20% in taxes on realized capital gains when selling an asset that is held longer than 12 months. The applicable capital gains rate also applies to qualified dividends received. Qualified dividends are those paid by U.S. companies or certain foreign companies. The highest rate of 20% currently applies to single tax filers with income over $445,850 and married couples filing a joint return with income over $501,600. For single people with incomes over $200,000 or married couples with incomes exceeding $250,000, an additional 3.8% Net Investment Income Tax applies.

Proposals under consideration would raise the applicable tax for capital gains and qualified dividends to the proposed highest marginal income tax rate, 39.6% for those with taxable income of $1 million or greater.[1] When combined with the Net Investment Income Tax, it would result in a total tax of 43.4% on long-term capital gains or qualified dividends for those earning more than $1 million per year.

The Net Investment Income Tax would also apply to all income exceeding $400,000 that is not otherwise subject to FICA or self-employment tax, even if it is not considered "investment income."[4]

Gains from the sale of assets held less than one year will still be considered short-term capital gains and subject to tax at ordinary income tax rates.

Carried interest tax

A provision of current tax law that primarily benefits private equity and hedge fund managers defines a category of income referred to as carried interest. This allows a good portion of income earned by these managers to be treated at the more favorable capital gains tax rate of 15% or 20%. Under new proposals, this form of compensation would be treated as wage income subject to employment taxes and a top tax rate of 39.6%. Capital gains tax treatment would still apply for investors with money at risk (i.e., private equity partners who invest their own money in their funds). Certain family partnerships would also be exempt from these tax law changes.[15]

Tax changes that could affect estate transfers and gifting

Estate tax exemption and estate tax rate

The TCJA raised the unified gift and estate tax exemption amount per person, and it now stands at $11.7 million. For estates valued at a larger amount, the top estate tax rate is 40%.

One proposal would establish a progressive taxation system for estates transferred at death, similar to the marginal tax brackets that apply to income.[6] The proposed brackets (with no cost-of-living adjustment) are:

Value of estate at death	Applicable estate tax rate
$0 to $3.5 million	0%
>3.5 million to $10 million	45%
>$10 million to $50 million	50%
>$50 million to $1 billion	55%
>$1 billion	65%

This proposal would also reduce the lifetime gift exemption to $1 million per individual and $2 million for married couples, with no cost-of-living adjustment. Lifetime gifts will reduce the $3.5 million estate tax exemption.

Changes in step-up in cost basis for assets transferred at death

Under laws that have been in place for an extended period of time, an asset that is inherited from a deceased individual would benefit from a step-up in cost basis. For example, if a stock an individual purchased at a cost basis of $10,000 had risen in value to $100,000 by the time that person died, the beneficiary of that stock would have the cost basis established at $100,000. This would avoid tax on the $90,000 gain that occurred while the initial owner held the stock.

Legislation has been proposed that would eliminate the step-up in cost basis for inherited and gifted wealth. In the example above, this would mean that along with inheriting a stock valued at $100,000, the beneficiary would also inherit a capital gains tax liability on $90,000 in appreciated value, significantly reducing the benefit of the inherited stock. This proposal includes certain transactions involving the sales and gifts to a grantor trust.[7] Among the specific provisions being considered are:

- Unrealized capital gains at death will be treated as "sold" assets upon transfer to a beneficiary. The difference between the deceased owner's cost basis and the asset's fair market value on the date of death,

or the alternate valuation date, will be taxed as a capital gain. However, this would apply only to the extent the gains exceed the $1 million exclusion.

- Tax on unrealized capital gains is due when capital assets (equities, real estate, equipment, etc.) are transferred by gift or sale to a "defective" trust if the property in the trust is not includable in the grantor's estate for estate tax purposes.
- Implementation of a "21-year rule" for all non-grantor trusts, whether newly created or pre-existing, that would impose payment of tax on unrealized capital gains every 21 years after establishment of the trust. A trust created in 2005 or earlier will have its first "deemed realization" in 2026. Income taxes owed from "deemed realization" on assets other than actively traded assets (i.e., illiquid assets) may be paid over a 15-year period.
- Income taxes paid on unrealized capital gains for assets, other than actively traded assets, would be deductible for estate tax purposes and payments can be spread out over 15 years.
- A $1 million exclusion would apply for property transferred at death, indexed for inflation in $10,000 increments (less any exclusion previously used for gifts).
- Up to $100,000 of the $1 million exclusion can be used during a person's lifetime, with any remaining amounts available upon death.
- There would be an exemption for gifts or bequests with unrealized capital gains that are directed to a spouse, a trust with a spouse as sole beneficiary or a charity. Under the spousal exception, unrealized capital gains on assets transferred to a spouse (or a trust with spouse as sole income beneficiary) will be taxed as ordinary income at the spouse's death.[8]

Taxation of large trusts and estates

A proposal has been made that would tax capital gains and qualifying dividends earned by trusts and estates at the same rate as applicable ordinary income tax rates for individuals with taxable incomes exceeding $1 million.[1]

Additional changes that could affect common estate planning techniques

Annual exclusion gifts

Under current law, individuals can gift up to $15,000 per year per recipient (to an unlimited number of recipients) and have those gifts excluded from gift tax. This allowed a couple to gift up to $30,000 per person in a year (with an unlimited number of recipients) with no gift tax ramifications. In addition, an individual could receive an unlimited amount of gifts from any number of donors.

A proposal has been made to reduce the maximum annual gift excluded from gift tax to $10,000 per recipient, with donors limited to total annual gifts of $20,000 that would be excluded from gift tax. In addition, no recipient could receive more than $10,000 per year.[3]

Grantor trusts

New rules, if approved, would treat the grantor of a trust as the "deemed owner" of trust assets. These rules would apply to all IRC Section 678 trusts, including Spousal Lifetime Access Trusts, Intentionally Defective Grantor Trusts, Irrevocable Life Insurance Trusts, Beneficiary Deemed Owner Trusts and Beneficiary Defective Inheritors Trusts.[3] As a result of this change:

- Assets would be included in the deceased grantor's estate at death and subject to estate tax.
- Distributions made to non-spouse beneficiaries during the grantor's life would be treated as gifts and subject to gift tax.
- During the grantor's life, when the grantor ceases to be the "deemed owner" of the grantor trust, trust assets attributed to the grantor as "deemed owner" would be treated as a transfer by gift and be subject to gift tax.

These proposed rules would apply to any grantor trust, created or receiving a contribution, on or after the date the new law is enacted (if that occurs). Grantor trusts created and funded ***prior*** to the date of enactment would be grandfathered under current law.

GRATs and similar arrangements

Under proposals being considered, Grantor Retained Annuity Trusts (GRATs) would require a minimum duration of 10 years. In addition, the GRAT would be required to have a minimum taxable "remainder interest," (the greater of 25% of trust value or $500,000) determined at the time of its creation.[3]

Generation-Skipping and "Dynasty" Trusts

Under proposed changes, the duration for each type of trust would be capped at 50 years. This new time limit on the life of such a trust would apply both to newly created trusts as well as those that existed prior to the new law being enacted. Upon expiration of the 50-year grace period, distributions from the trust to a "skip person" would be subject to the generation-skipping transfer tax.[3]

Valuation discounts

Legislation is under consideration that would disallow valuation discounts on the transfer of non-business assets held in business entities (i.e., partnerships and LLCs) and partial interests in entities that are majority-owned or controlled by members of the same family. Current law does not impose such limitations. Certain family limited partnerships would be excluded from these changes.[3]

Potential changes to taxes for businesses and business owners

Along with the proposals noted above related to taxation of personal income, gifts, trusts and estates, there are proposals that could significantly affect businesses and business owners. Among the notable modifications included in the TCJA of 2017 was a reduction in the corporate income tax rate from 35% to 21%. Here are potential changes that are now being considered:

- **Repealing the deduction applying to pass-through entities for high-income earners.** The TCJA implemented the ability for owners of sole proprietorships, partnerships, S-Corporations and LLCs to claim a 20% tax deduction for qualified business income. For taxpayers with income over $400,000, President Biden has proposed repealing the pass-through deduction provided via a phase-out formula for high income earners.
- **Change in the corporate tax rates**. The current 21% corporate income tax rate would be raised by a modest amount, possibly to 25%. Current proposals would also put an end to the current tax exemption on the first 10% return on foreign assets for companies that are subject to the Global Intangible Low Tax Income ("GILTI"). These proposals would also increase the minimum GILITI tax to 21%. Also under consideration is a 15% minimum income tax on financial statement profits for companies with more than $2 billion in net book income that might otherwise not be taxed.[9]
- **Other provisions that affect specific industries.** A range of proposals is being considered, including a financial risk fee on financial institutions with more than $50 billion in assets, eliminating the tax deduction for the costs of direct-to-consumer prescription drug advertising, imposing a tax on pharmaceutical companies if drug price increases exceed inflation and an expansion of clean energy tax initiatives.[10]

Business owners should also be aware of how potential changes in capital gains tax laws could affect the net proceeds received from the sale of a business or ownership position in a business. The tax liability from such a transaction could be nearly doubled, depending on specifics of the final legislation passed and the business owner's financial circumstances. Family members who inherit business assets would also face greater tax liability if the step-up in cost basis at the death of the owner were eliminated.

Increased enforcement of tax laws

Enforcement of tax laws, primarily through the auditing process, has declined in recent years. Funding is being proposed to boost enforcement activity by the IRS. It would primarily be focused on large corporations, businesses, and estates and higher income individuals. Also included in the package are requirements that

financial institutions report information on account flows. This would require the reporting requirements on earnings from investments and business activity similar to rules that already apply to reporting on wages.

How markets may react to changing tax laws

The White House proposal that would raise the corporate income tax rate to 28% has the greatest odds of affecting the investment markets. As noted above, Congress is more likely to consider a smaller increase in the corporate tax rate. If so, it may limit the potential fallout for markets.

Keep in mind that corporate tax policy changes affect companies and industries differently, depending on the details of the new law. Most companies pay a tax rate that diverges from the statutory corporate tax rate, because each face unique tax situations. The actual, or effective, tax rate paid by individual companies — and the average effective rate affecting certain industries and sectors — depends on details yet to emerge in Congressional negotiations. Some industries will see larger tax increases than others, making it likely that the legislation will impact sector and industry performance more than it does the broader market.

While the corporate income tax rate increase has the greatest chance of impacting medium to long-term sector and industry performance, raising the capital gains tax on high earners and changing step-up-basis rules has the potential to contribute to short-term market volatility. Yet, Congress may soften the capital gains tax rate increase and step-up-basis rules compared to current proposals. The effective date of the capital gains tax increase is also a factor.

If the tax increase is retroactive, an extremely unlikely outcome, investors would have no opportunity to realize gains before the increase takes effect. If the effective date of any new law is some time after the law passes, either later in 2021 or January 1, 2022, investors may rush to realize gains, causing a wave of selling. Related to this, market participants may anticipate, or “front-run,” expectations of investors selling to realize gains at the lower tax rate. The risk of such a selloff depends largely on the magnitude of the capital gains increase proposed in Congress, and how much time is available for investors to react or plan ahead.

History, however, provides valuable perspective. The prior two capital gains tax increases, on January 1, 1987, and on January 1, 2013, had a negligible impact on markets. There was no downtrend in prices prior to or after each increase, though the tax rate increases — both about 8% — were smaller than the current White House proposal.

Ultimately, this means the tax policy’s market-impact is largely dependent on yet unknown details. At the same time, the tax policy will couple with spending measures that are supportive to certain sectors of the market. Just like tax policy changes will have a varying impact on companies, tax changes will have varying impacts on investors. Individual investor concerns may vastly outweigh concerns for the broader market.

Tax-saving steps to consider today

Far-reaching potential tax changes could have a dramatic impact on some individuals and estates. Therefore, it makes sense to understand how these possible alterations to the tax code could apply to your own circumstances and how tax changes might affect the way you position your assets.

Individual investors should carefully consider the potential for changes to long-term capital gains tax rates as they assess their own portfolios. Investment decisions should consider more than tax policy changes and tax consequences, but tax is an important factor in investment decision-making. If you hold appreciated assets that you are already considering selling, you may wish to lock in those gains before any potential tax increase is applicable.

Those with large estates that could be subject to increased estate tax liability, potentially beginning in 2022, will want to explore planning options in the interim. Among the strategies to consider is the establishment of grantor trusts and gifting significant assets to take advantage of today’s higher exemption amounts.

Here are some additional steps you may wish to consider to help position yourself as favorably as you can in the event tax increases are enacted into law:

- **Accelerate income into 2021**. This can include Roth IRA conversions and taking gains in Intentionally Defective Grantor Trusts.
- **Defer deductions**. If tax rates rise in the future, delaying deductions until 2022 or beyond will help temper the impact of those increases.
- **Invest in life insurance policies**. Proceeds are generally not subject to income tax.
- **Step up gifting.** Make significant gifts in 2021 to take full advantage of the current expanded unified gift/estate tax exemption amount and reduce the size of your estate.
- **Realize capital gains on highly appreciated assets during your lifetime**. If the step-up in cost basis is eliminated, taking gains while you are living and paying taxes on the gain will reduce your estate and the amount of estate taxes due while limiting the tax burden on beneficiaries.

It's important to remember that many things could change between what is being proposed today and what may eventually be enacted into law. We will continue to monitor the evolving tax policy debate and inform you of important developments as they emerge.

Talk with your U.S. Bank wealth professional if you have questions about the potential impact on your own situation and financial plan. You should also check with your tax and legal advisors. We stand ready to assist you and will keep you informed as likely outcomes stemming from the 2021 legislative agenda come into sharper focus.

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[1] "The American Families Plan," proposed by President Joe Biden, April 28, 2021.

[2] Provisions Affecting Payroll Taxes," Social Security Administration (https://www.ssa.gov/OACT/solvency/provisions/payrolltax.html#E3).

[3] "Securing a Strong Retirement Act of 2021," introduced by Rep. Richard E. Neal (D-MA), May 4, 2021.

[4] Tidgren, Kristine, "A Look At The American Families Plan," *Ag Docket,* Iowa State University, May 5, 2021.

[5] "Carried Interest Fairness Act of 2021," introduced by Rep. Bill Pascrell (D-NJ), Rep. Andy Levin (D-MI) and Rep. Katie Porter (D-CA), Feb. 15, 2021.

[6] "For the 99.5 Percent Act," introduced by Senator Bernie Sanders (I-VT), March 25, 2021.

[7] "Sensible Taxation and Equity Promotion (STEP) Act," introduced by Senator Chris Van Hollen, et. al, March 29, 2021.

[8] U.S. House Resolution 2286, proposed by Rep. Bill Pascrell (D-NJ), March 29, 2001.

[9] U.S. Dept. of The Treasury, "The Made in America Tax Plan," April 2021. (https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf)

[10] The White House, "Fact Sheet: The American Jobs Plan," March 31, 2021. (https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/)

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