

# Westshore Wealth *Insights*

## The Build Back Better Act

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## **What the Government Gives, It Must First Take Away – John S. Coleman**

President Biden has an agenda to provide trillions of dollars in funding for investment in infrastructure. The administration is calling for two types of infrastructure to be invested in: “hard” and “human”. “Hard infrastructure” includes investment in transportation, energy, broadband, and other traditional categories of infrastructure. “Human Infrastructure” includes payments to low- and middle-income families, training programs, education subsidies, caregiving assistance, and other policy priorities.

In order to pay for these investments, President Biden has suggested several ways to offset the costs. On September 13<sup>th</sup> the House Ways and Means Committee released their draft of the most recent proposed legislation that could bring significant tax changes to individuals and businesses as part of a budget reconciliation bill referenced as the Build Back Better Act. The bill still must move to the Budget Committee, then to the House Rules Committee, then to the House floor for a vote, then to the Senate floor for a vote and finally, to President Biden’s desk to be signed into law. As with anything that moves through the legislative process, there will be many changes before anything becomes official, but the draft text from the House Ways and Means Committee means we are getting closer to a final version that may be passed. Even though the bill has yet to become law, it’s important to understand what the bill contains and review planning opportunities before the window closes.

Our current tax rates were signed into law by President Trump on December 22<sup>nd</sup>, 2017 as part of The Tax Cuts and Jobs Act (TCJA). It was the largest overhaul of the tax code in three decades and wasn’t set to expire till the end of 2025. Now, with President Biden’s desire to invest in infrastructure, he will have to undo most of the TCJA and even go a step further in most cases to pay for his plan.

**Increase the Ordinary Income Tax Top Bracket to 39.6%**

The first step will be to increase the ordinary income tax top bracket to 39.6%, which is where it was prior to the passage of the TCJA. If enacted, the bill would permanently reinstall 39.6% as the top ordinary tax bracket effective January 1<sup>st</sup>, 2022. To take it a step further, the bill lowers the amount of income a taxpayer can have before finding themselves in the top tax bracket.

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

As you can see, the most impacted group to this change is the individuals and families that are in the 35% bracket because they would see a 4.6% increase to their tax rate where the highest tax bracket only sees an increase of 2.6%. Our recommendation for these individuals in the highest tax brackets would be to consider accelerating their income for 2021, if they are able to, because any income in 2022 would be assessed these higher rates.

**Increase the Long-Term Capital Gains Top Bracket to 25%**

The next step in President Biden’s plan is to increase the long-term capital gains top bracket to 25%. The current 20% rate was introduced on May 6<sup>th</sup>, 1997 when the Taxpayer Relief Act of 1997 reduced the top long-term capital gains bracket from 28%. You’ll also notice, like the ordinary income tax rate adjustment, the brackets are moved to lower thresholds for the highest bracket.

<b>Capital Gains Tax Rates Under the Proposed Bill</b>				
	<b>Single</b>		<b>Married Filing Jointly</b>	
	<b>Current</b>	<b>Proposed</b>	<b>Current</b>	<b>Proposed</b>
<b>0%</b>	\$0 - \$40,400	\$0 - \$40,400	\$0 - \$80,800	\$0 - \$80,800
<b>15%</b>	\$40,401 - \$445,850	\$40,401 - \$400,000	\$80,801 - \$501,600	\$80,801 - \$450,000
<b>20%</b>	\$445,851+		\$501,601+	
<b>25%</b>		\$400,001+		\$450,001+

However, unlike the ordinary income tax rate, the bill aims to treat any gains incurred after September 14<sup>th</sup>, 2021 with the new rates. The bill does provide a narrow exception that would exempt gains if there was a bona fide contract in place prior to September 13<sup>th</sup>. One of the major questions that we have been receiving from clients is whether Congress can do this. Our answer is what Congress can do, and what Congress will do are not necessarily the same thing. Retroactively increasing taxes, as you can imagine, would likely be unpopular since no one would have the chance to plan for the increase.

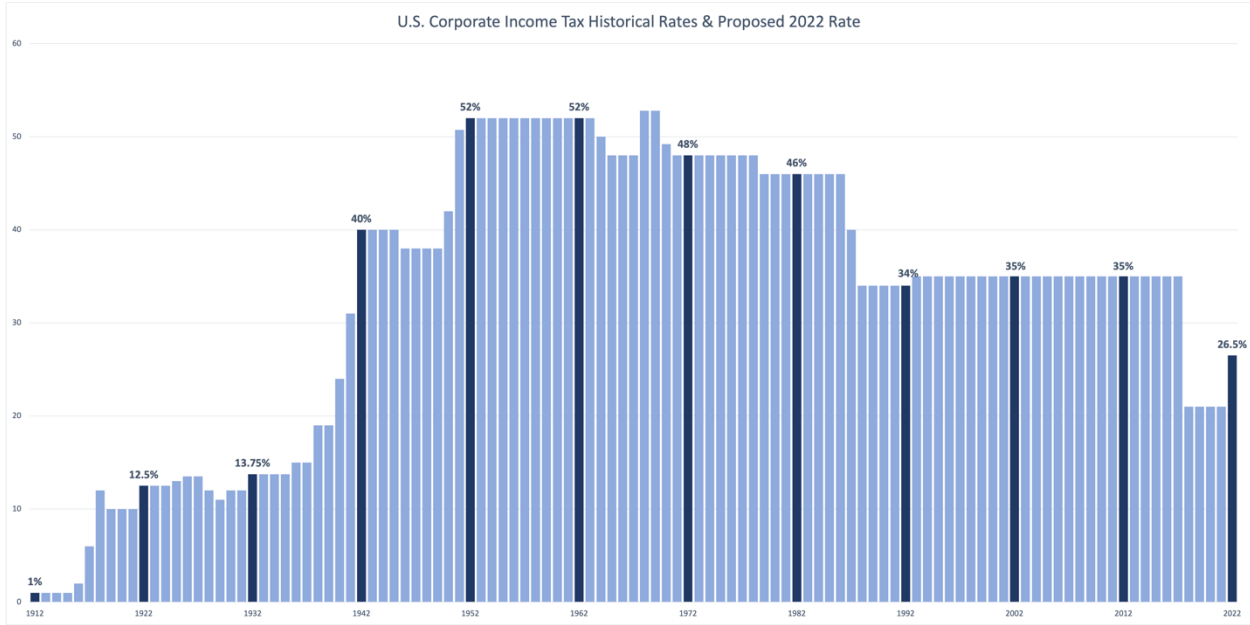
The last time a retroactive tax increase was enacted was 1993 as a part of the Omnibus Budget Reconciliation Act which increased the top ordinary income tax rate to 39.6% and the estate/gift tax rate to 55%. The difference between 1993 and today is that the Democrats in 1993 could afford to lose a lot more votes and still pass the law. Notably, in 1993, more than 40 Democrats voted against the bill in the House. Today, if even a handful of democrats vote “No” in the House, it would likely doom the bill. It’s even worse in the Senate since it is currently split 50-50 between Democrats and Republicans. Since retroactive tax increases are particularly unpopular, the likelihood of at least one Democrat in the Senate not voting “Yes” is likely which could derail the entire bill. Our guess is that this won’t make it to the final bill that is voted on.

Please note that single taxpayers with modified adjusted gross income in excess of \$200,000 (\$250,000 for married taxpayers filing jointly) will continue to be assessed an additional 3.8% net investment income tax (NIIT) on their long-term capital gains and qualified dividends, which effectively results in a maximum rate of 28.8% under the proposed Act.

## Increase the Corporate Tax Rate Top Tax Bracket to 26.5%

The top “C” corporation tax rate would be 26.5% which is an increase from the existing 21% flat rate put into place under the TCJA. Additionally, a graduate corporate tax would be reintroduced. However, for corporations with taxable income over \$10,000,000 an additional 3% tax is imposed not to exceed \$287,000 – which essentially eliminates the benefits of the lower tax rates for larger corporations and essentially creates a flat tax of 26.50% for those corporations making over \$19,566,667.

Proposed Corporate Tax Rates		
Current	Proposed	
21%	Not over \$400K	18%
	\$400K - \$5MM	21%
	Over \$5MM	26.50%
	For Corporations that exceed \$10MM, an additional 3% is imposed not to exceed \$287K	



Please note that corporate income is taxed at the entity level while capital gains and qualified dividends are taxed at the shareholder level. This is called the integrated tax rate. Under the Build Back Better Act, the United States integrated corporate tax rate would raise from 47.4% to 56.6% due to the increase in corporate tax rates and capital gains rates.

### **Reduce the Unified Credit Amount for Estate and Gift Taxes**

Another step in the Build Back Better Act is to decrease the estate and gifting exemption which would ultimately increase estate taxes. The TCJA adjusted the estate and gift tax exemption from \$5MM per person to \$10MM. The adjusted inflationary number is \$11.7MM per person in 2021, although this was set to expire on December 31<sup>st</sup>, 2025, and would revert back to the inflationary adjusted \$5MM. The Build Back Better Act would decrease this number back to around a \$6MM inflationary adjusted number effective January 1<sup>st</sup>, 2022.

For many individuals and families, the adjustment to around \$6MM per person is a huge deal. For example, if you are a single individual and you pass away with a \$10MM estate, your heirs would owe nothing in 2021 because you have an \$11.7MM exemption. However, if the act is passed and you pass away in 2022, your heirs would owe around \$1.6MM (assuming a 40% estate tax rate) to Uncle Sam because your exemption is lowered to \$6MM.

So, you might ask, what do I need to be thinking about in 2021? Many individuals and families are considering utilizing their gifting exclusion in 2021 before it potentially drops to \$6MM. Using a similar example as the previous one, assume you are a single individual worth \$10MM. You could utilize the existing rules and gift \$8MM into an irrevocable trust (there are many different variations and beyond the scope of this article) that resides outside your estate. You pass away in 2022, when the new rules are in place, and are left with a \$2MM estate. Since you made an \$8MM gift, you no longer have any exemption since you used the \$8MM gift and there is only a \$6MM exemption. However, you are now only exposed to \$800K in estate taxes rather than \$1.6MM due to the gifts that you made.

Please note that this is a very simple example and the strategies that we might employ in year-end planning are much more complicated and we would hope to end up with much better results. The challenge at this point is working with attorneys to get the strategy executed since everyone is rushing out to get their strategies implemented. At a minimum, we recommend beginning to think through the strategies that will benefit you to make sure your wishes are carried out while minimizing your overall tax bill.

### **Restrict Roth IRA Conversions, Back Door Roth IRAs and the Creation of Mega Roth IRAs**

The Roth IRA was enacted in 1997 and changed the way many individuals saved for retirement. Dollars go in after-tax, grow tax-deferred and are 100% tax-free when withdrawing funds. As soon as it was passed, individuals began looking at their traditional IRAs and 401(k)s to see if it made sense to pay the taxes today by converting those accounts to Roth IRAs. However, if their adjusted gross income was too high, they couldn't convert. In 2010, President Obama changed the law and allowed anyone to convert their pre-tax retirement accounts to Roth IRAs. Individuals also figured out they could contribute to an after-tax IRA and immediately convert to a Roth IRA without any tax consequences. Since the Roth IRA was enacted in 1997, legislation changed to allow individuals to contribute to Roth 401(k)s which allow much larger contributions on an annual basis.

The Build Back Better Act strives to restrict what Congress considers an abusive practice of these types of IRAs by adjusting the rules as follows:

- **Prohibit Roth Conversions for High-Income Taxpayers**

The proposal would eliminate a conversion from a traditional IRA or 401(k) to a Roth IRA for any taxpayer with adjusted taxable income that exceeds \$450,000 for a joint return or \$400,000 for an individual return. It's important to note that most proposals in the Act go into effect at the beginning of 2022, this would not take effect until 2032. You may be wondering why this one doesn't take effect until then and the answer is

very simple, the government wants the tax money today. By allowing the conversions to continue for another 10 years, the government continues to take in the tax revenue that can be used for budget projections.

- **Eliminate Back Door Roth IRA Conversions**

The proposal would prohibit all after-tax amounts held in non-Roth accounts in an employer sponsored retirement plan or a traditional IRA from being converted to a Roth IRA and would apply to distributions, transfers, and contributions made after December 31, 2021.

- **Prohibit IRA investments Conditioned on Account Holder's Status**

Investments can take on many different forms and have different requirements. This restriction would no longer allow Roth IRAs to be invested in instruments designed for qualified and accredited status. Please note that, according to the act, if a Roth IRA is already invested in such instruments, individuals would have until December 31<sup>st</sup>, 2023 to get rid of such investments or lose their Roth IRA status.

- **Increase in Required Minimum Distributions for High-Income Taxpayers**

The Act would require that individuals who are in the highest tax bracket and have over \$10MM in retirement accounts to begin taking Required Minimum Distributions (RMDs). This rule applies to all types of retirement accounts, not just Roth IRAs. The amount of the RMD would be equal to 50% of the total retirement account dollars in excess of \$10MM and less than \$20MM, plus 100% of the total amount in retirement accounts in excess of \$20MM. The rules also state that these individuals must first use Roth IRAs to satisfy their special RMD requirements. Next, they can use their Roth 401(k)s to satisfy requirements. Only when their Roth accounts are exhausted do they move on to their traditional IRA and 401(k) accounts.



### **3% Surtax for Ultra-High Income Taxpayers**

The Act would create a new 3% surtax on high-income individuals, estates and trusts. This tax would be applied on taxpayers with modified adjusted gross income above \$5 million which applies to both single and married taxpayers. The tax applies to estates and trusts with income exceeding \$100,000.

Although few individuals would qualify for this surtax on an annual basis, it's important to note that a sale of a business or piece of property could make you subject to this surtax. It's also important to note that since trusts have a threshold of \$100,000, these instruments could easily reach the level where they would be required to pay the surtax.

### **3.8% Net Investment Income Tax (NIIT) to High-Income S-Corporation Owners**

Under current tax law, the profits of S-Corporations are neither subject to employment taxes or the Net Investment Income Tax. However, under the new Act, there would be significant expansion of the net investment income tax. This change would now apply the tax to active business income of "S" corporation shareholders and partners. This tax would apply to taxpayers with taxable income exceeding \$400,000 single and \$500,000 married filing jointly.

### **Defective "Grantor" Trusts Eliminated**

For years, advisors and attorneys have used defective grantor trusts to remove assets from a client's estate. We have used this strategy with multiple clients over the years. The premise of most trusts is to create a standalone entity (the "trust") that owns property and is taxed as its own distinct entity, separate from the income and estate taxes that apply to the individual that contributed property to the trust ("grantor"). There have been many provisions enacted over the years that speak to this exact issue. However, the provisions that cause a trust's assets to be treated as the grantor's for income tax purposes are not the same as the provisions that do so for estate taxes. Therefore, these trusts are termed "defective" since the tax rules currently conflict with each other.

The Act would more closely align the income tax and estate tax rules for grantor trusts by imposing estate tax consequences on certain assets held in or distributed from a grantor trust. This would basically pull certain grantor trusts into the grantor's estate. Also, any transfer to these trusts might result in the realization and recognition of gain. However, the Act would only be effective for trusts created on or after the date of enactment and any transfers made to the established trust after the date of enactment.

### **Family Limited Partnerships (FLPs) Discounts Curtailed**

One of our favorite estate planning strategies, that may be considered one of the most controversial, is utilizing Family Limited Partnerships (FLPs) to transfer assets at a discount to their heirs. The basic concept is simply that a minority interest in a nonmarketable "family" business is something that a third-party buyer would not pay "full price" for. Instead, the buyer would reasonably expect a discount to own an interest in a family business that they did not control and had limited ability to sell. This in turn, would allow the owner of the Family Limited Partnership to discount the value of the assets contained inside the partnership and reduce the amounts to be sold or gifted to their children or trusts for estate planning purposes.

To address this, the Act would look to eliminate valuation discounts for certain non-business asset transfers. Non-business assets are defined as any passive investment (e.g. cash, stocks, mutual funds, etc.) not used in the active conduct of a business. The effective date of this proposal is the date of enactment.

### **Steps to Consider**

At Westshore, our goal is to listen to our clients' needs and identify strategies that will help them achieve their objectives. As mentioned earlier, the challenge with the Build Back Better Act is that it may see many iterations before anything is passed and we have limited time to act. There are many challenges ahead, but as always, we are open to discussing any strategies with you to help improve your overall financial situation.

## Important Disclosures

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