

Advisory Commentary

2021 Tax Proposal – Overview, Observations, and Opportunities

September 24, 2021

Last week, the House Ways and Means Committee shared its tax proposal to pay for the \$3.5 Trillion Build Back Better Act (the “Act”). This article will focus on a summary of key provisions that will affect individuals, including our observations and key planning opportunities.

We recognize that tax proposals remain only proposals until they become law and negotiations will continue within Congress. Still, we appreciate your desire to stay ahead of these conversations as they evolve, especially if planning windows may close.

Estate and Gift Taxes

Current law provides each individual with an exemption of \$10 million indexed for inflation. This means that each taxpayer has a combined gift and estate with separate generation-skipping transfer tax exemptions of \$11.7 million as of this year.

These exemptions are currently scheduled to decrease by one-half on January 1, 2026. The proposal would accelerate this time table and decrease the current exemptions by one-half as of January 1, 2022.

OBSERVATIONS

Contrary to prior discussions, the proposal does not change the current 40% tax rate; it also does not include a retroactive beginning date. Proposed changes to valuation discounts and to grantor trusts, however, will otherwise limit particular current available planning techniques going forward.

OPPORTUNITIES

We recommend clients consider using current exemptions to fund gift trusts by year-end or sooner if grantor trusts are involved. We also recommend careful consideration of any transfers involving valuation discounts in light of pending changes to those rules described below.

Valuation Discounts

Current law allows for valuation discounts when families transfer private business and other non-marketable assets through family partnerships and limited liability companies. Families have used these structures to also transfer publicly traded stocks, although court cases have limited the effect of these strategies over time.



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The proposal would still allow discounts for transfers of family operating businesses, but it would eliminate discounts on transfers of publicly-traded securities. The proposal would accomplish this by requiring families to separate all transfers into (1) non-business assets that would receive no discount followed by (2) operating businesses that could be subject to valuation discount.

OBSERVATIONS

The proposal would apply these new valuation rules from the date it becomes law.

Congress has been trying to limit these popular estate planning techniques for over 30 years. Prior legislative attempts have left these techniques available unless limited by court cases when families have not met required formalities.

OPPORTUNITIES

For families who have these structures in place, there remains a limited window to complete transfers or to revisit compliance with current laws. For families who have not yet created these structures, the available window to do so is closing rapidly and other techniques may provide more value here.

Grantor Trusts

Current law includes a disconnect between estate and gift tax compared to income tax rules. This allows someone to move assets out of the estate while remaining the owner for income tax purposes. These types of trusts are referred to broadly as "grantor trusts".

Grantor trusts come in a variety of forms and names that are designed to achieve family gift trust planning, including:

- GRATs - grantor retained annuity trusts;
- SLATs - spousal lifetime access trusts;
- ILITs - irrevocable life insurance trusts;
- IDGTs - intentionally defective grantor trust;
- BDITs - beneficiary defective inheritance trusts.

Grantor trusts provide special benefits to families including options to sell assets at low interest rates and to exchange assets between the grantor and trust while avoiding income tax events along the way. These planning techniques have otherwise withstood scrutiny by courts for decades and have helped millionaires next door as well as billionaires shift wealth to families tax-free.

The proposal would limit the use of grantor trusts by subjecting them to estate tax, by taxing distributions from them as gifts and by taxing sales to or exchanges between them as capital gains.



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OBSERVATIONS

The proposal would apply these new grantor trust rules from the date it becomes law. Existing and funded grantor trusts would be grandfathered under current law.

OPPORTUNITIES

Anyone who has not yet created a grantor trust should do so and complete funding prior to any change of law if possible to remain under current law. Anyone with an existing grantor trust should complete funding and review administrative flexibility to remain grandfathered under the proposal.

Individual Income Tax Rates

Current law provides a top marginal income tax rate of 37 percent. The proposal would return the top marginal income tax rate to 39.6 percent. This top rate would apply to those with modified adjusted gross income over:

- \$450,000 for married individuals;
- \$425,000 for heads of households;
- \$400,000 for unmarried individuals; or
- \$12,500 for trusts and estates.

OBSERVATIONS

The proposal returns top marginal income tax rates to prior levels preceding the current tax act. The new higher tax rate would apply beginning January 1, 2022.

OPPORTUNITIES

Anyone affected by this change should review projected income for this year and next and consider accelerating or deferring income to take advantage of the changing rates. Anyone affected also should consider timing available deductions, including charitable gifts, as part of this analysis.

Capital Gain Taxes

Current law applies a maximum 20 percent rate to long-term capital gains. The proposal would increase this maximum long-term capital gains rate to 25 percent for sales beginning September 13th, absent a binding contract for sales completed by year-end.



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OBSERVATIONS

Absent a binding sales contract, the higher capital gains rate would apply to any sales beginning September 13th. Expect this proposal to become subject to negotiation by Congress or possible court challenges if unchanged.

OPPORTUNITIES

As a reminder, the “tax tail should not always wag the dog” when managing investments. Maintaining a focus on planning goals driven by a long-term investment approach remains prudent here.

In the meantime, remember that tax loss harvesting to offset gains remains available along with funding charitable gifts through appreciated stock. Personal lending alternatives also remain available to provide liquidity while tax and investment landscapes change.

New Income Surtax

Current law does not include a specific surtax on highest taxpayer income. The proposal would change this by adding a 3 percent surtax to those with modified adjusted gross income over:

- \$5 million for married individuals;
- \$2.5 million for unmarried individuals; or
- \$100,000 for estates and non-charitable trusts.

This additional surtax would apply beginning January 1, 2022.

OBSERVATIONS

The proposal would raise the highest tax rates to 31.8 percent on capital gains and 46.4 percent on ordinary income for those subject to both the new surtax and existing net investment income surtax that supports health care.

OPPORTUNITIES

With each new tax act, annual tax planning become more important. This proposal highlights the importance of strategies that time income, smooth income, relocate income (state taxes) or distribute income to trust beneficiaries at lower marginal rates.



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Retirement Accounts

Current law promotes retirement plan growth for all taxpayers including those with ultra-high net worth. Discussions involving the relative “fairness” of these laws arose when Mitt Romney ran for President in 2012 prompting proposals to cap retirement account benefits overall.

The proposal would restrict retirement accounts for all taxpayers by eliminating “back door Roth conversions” by allowing only taxable Roth conversions effective January 1, 2022.

The proposal would further restrict retirement accounts ***for those subject to the top marginal income tax rate by:***

- Prohibiting all Roth conversions effective January 1, 2032; and
- Prohibiting all retirement account contributions (except for SEP and SIMPLE IRAs) once the total account values exceed \$10 million.

The proposal also would require mandatory distributions for combined retirement account balances (IRA, Roth and defined contribution plan accounts) equal to:

- 50 percent of excess accumulations over \$10 million; and
- 100 percent of excess accumulations over \$20 million.

For this purpose, excess amounts would be distributed first from Roth accounts.

Finally, the proposal would prevent the following investments in IRAs:

- Any private placement investments beginning January 1, 2024;
- Public company investments once individual ownership exceeds 10 percent; and
- Non-public company investments of any kind by an officer.

OBSERVATIONS

The proposal is designed to target high retirement account balances and any variety of back door Roth conversions by subjecting high balance retirement accounts to tax or distribution sooner.

OPPORTUNITIES

Outstanding back door Roth conversions should be completed by year-end.

Automated back door Roth conversion strategies should be terminated beginning next year.

Traditional Roth conversion opportunities should be implemented by 2032 as permitted.



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Those with higher combined retirement account balances should monitor and adjust investment strategies to avoid forced distributions of high balances.

Anyone with private placement investments in IRAs also should begin divesting by January 1, 2024.

Corporate Taxes

Current law provides for a flat rate of 21 percent on corporate income. The proposal would replace this with a graduated corporate income tax rate of:

- 18 percent up to \$400,000;
- 21 percent up to \$5 million; and
- 26 percent thereafter.

The graduated rate above would phase out for corporations with income over \$10 million.

OBSERVATIONS

The proposal calls for graduated and lower rates than the 28 percent flat rate originally discussed. S Corporations created prior to May 13, 1996, have an opportunity to reorganize tax-free before January 1, 2024.

OPPORTUNITIES

If this proposal becomes law, there will remain a window until 2024 for S Corporations to revisit tax structure. Family S Corporations should weigh income, cash flow and expenses (costs, state and local or payroll taxes) when choosing to be taxed as a C Corporation or partnership.

REMAINING THOUGHTS

The proposal notably omitted discussion of hot topics including the (1) state and local tax (SALT) deduction, (2) elimination of the basis "step-up" for income tax purposes at death and (3) changes to 1031 like-kind exchange rules.

We recognize the proposal's ultimate outcome remains uncertain. Although we have no crystal ball, we believe tax increases remain likely and only question the timing and details of these increases. We hope this overview provides you some color around targets for change and an invitation to discuss with your advisor how these changes may affect you.



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