FLP Financial Planning

Throughout the year, we've paid close attention to the negotiation of tax code changes in Washington D.C. There are currently several income and estate tax proposals before Congress – all with varying characteristics and nuance. While we do not know exactly what will be adopted or when it will be implemented, we believe it is likely that income taxes for high income families will increase from current rates. We also believe that the estate tax exemption will be reduced from its current level. These proposals have garnered meaningful attention from the media and many of our clients have been wondering if or how they will be impacted. Here are some of the questions we've been hearing – and how we've been answering them.

> The *Tax Cuts and Jobs Act of 2017* included several temporary reductions/cuts/limits that are scheduled to expire ("sunset") on December 31, 2025. Some of the proposals before Congress suggest an acceleration of that sunset date. You'll see this mentioned a few times as you read.

Are my taxes going to go up?

Taxes are likely to go up for individuals in the top bracket. The current top income tax bracket of 37% is set to sunset back to 39.6% in 2025 (*see above*). Current proposals would accelerate the expiration of that tax break to December 31, 2021. In addition, the income threshold could be considerably lower. The current threshold for the top bracket is $628,300 for married filing jointly and $523,600 for single filers. The proposal from the Ways and Means Committee would apply the 39.6% top rate at $450,000 and $400,000 (respectively). These amounts mirror 2013 thresholds (unadjusted for inflation). While a compromise is likely on the precise dollar threshold, or different phased levels may be determined, it is likely that high earning households will be impacted by these changes. Those individuals in lower brackets will likely not be affected.

I am in the top bracket – what can I do?

Some clients are accelerating 2022 income into 2021 to avoid the potential additional 2.6% federal tax. One way to do this is to take additional distributions from tax deferred accounts – paying more taxes in 2021 (at a lower marginal rate) but reducing the dollar magnitude of future required distributions and taking advantage of the current lower rate. Such strategies should be considered only with the input of a tax professional.

Are capital gains tax rates going up?

As with income tax rates, current capital gains tax thresholds are set to expire after December 31, 2025 – moving back to prior (lower) levels. For reference, the current thresholds and corresponding rates are shown in the table below. For taxpayers with net investment income over $200,000 (single) and $250,000 (married filing jointly), an additional 3.8% on long-term capital gains and qualified dividends applies – this is called the Net Investment Income Tax (NIIT). There are a few varieties of proposals on changes to capital gains:

- Accelerate the "sunset" expiration date to gains realized after September 13, 2021, leading to lower thresholds for current capital gains rates
- Aligning capital gains rates with ordinary income thresholds and marginal rates – for a potential highest rate of 39.6% (plus NIIT as applicable, or 43.4%).
- Aligning capital gains with ordinary income as above, but only for taxpayers with adjusted gross income greater than $1 million.

Long-term capital gains tax rates for the 2021 tax year based on taxable income

Filing Status	0% Rate	15% Rate	20% Rate
Single	Up to $40,400	$40,401 - $445,850	Over $445,850
Married filing jointly	Up to $80,800	$80,801 - $501,600	Over $501,600
Married filing separately	Up to $40,400	$40,401 - $250,800	Over $250,800
Head of household	Up to $54,100	$54,101 - $473,750	Over $473,750

Source: Internal Revenue Service

At this stage, we aren't sure exactly *what* will come of this. But for those earners in the higher brackets, there is likely to be some increase to capital gains taxation – either in the threshold for higher rates, or the rates themselves.

Since so much is unknown, is there anything that I can do?

Consider taking advantage of today's potentially lower rates to harvest some additional capital gains this year and re-position part of your portfolio. Check with your investment advisor for their "wish list" for your portfolio and coordinate with your CPA on a tolerable capital gain budget.

If rates go up in the future, consider using low-basis stock for charitable giving or family support. This technique is a perennial favorite for achieving your goal of support while allowing the recipient to sell the holdings tax free (charity) or at a lower rate (family member), while you avoid paying the gain altogether.

Do we know anything about the estate tax exemption? Will it be reduced?

The 2021 estate tax exemption is $11,700,000 per person. Under current law, this exemption will sunset on December 31, 2025 – reverting to previous levels (plus inflation), which is estimated to be $6,020,000 per individual. One current proposal would accelerate that expiration date to December 31, 2021. If this comes to pass, some individuals/families with large estates may need to revisit their estate plans sooner rather than later to accommodate this reduced exemption.

Is there anything I can do to preserve a higher exemption for my estate for the benefit of my children and grandchildren?

If you are worried about the lower estate exemption amount of $6,020,000 per individual, there are some techniques to consider. In 2019, the Treasury and the IRS published final regulations that prevent a higher exclusion amount from being "clawed back" if the exclusion amount on the date of death is lower than the exclusion amount on the date of a gift. Accounting services firm KMPG observes that by making gifts before the end of 2021, an individual can utilize as much of their currently available gift tax exclusion as possible. There are, however, many complicating factors involved in such a strategy – both tax and non-tax related. If you are contemplating large gifts, it is best to schedule a meeting with your estate attorney and FLP advisor as soon as possible. The ability to maximize the use of the current exemption through large current gifts will be optimal for only a small number of people – but could be beneficial in the long run.

We keep hearing about plans to put a lid on retirement account balances. What is proposed there?

A proposal from the Ways and Means committee would require higher required minimum distributions (RMDs) for large tax-deferred retirement accounts. The proposal affects individuals with total tax-deferred account balances in excess of $10 million and adjusted gross income of over $400,000. Once the $10 million retirement account total is reached, 50% of the amount in excess of $10 million would be required to be withdrawn with a 35% withholding rate – regardless of the age of the account owner. We'll be watching this proposal closely.

What about Roth conversions? Is that a good idea this year?

Under current law, taxpayers can "convert" tax-deferred assets to a Roth IRA by paying income tax on the value of the converted funds. One proposal suggests eliminating this option for taxpayers earning more than $400,000 (individuals) or $450,000 (married filing jointly). The proposal also eliminates so-called "backdoor" Roth contributions, a popular technique for individuals with income too high to make traditional Roth contributions. This proposal would be effective for tax years 2022 and onward. As such, this is a good year to consider Roth conversions if you have high income. Talk to your advisor and CPA about whether this may be a good fit for you.

Final word

There are numerous other proposals that affect "S" Corporation business owners, Grantor Trusts, Tax-Deferred Exchanges, and valuation techniques that are too complicated to discuss here. Most, if not all, of these proposals will require compromise before becoming law – so it is impossible to predict outcomes at the time of this writing. With that being said, we believe that high-earning individuals/families will likely be impacted by tax code and estate-exemption changes. As such, we suggest that those individuals begin a dialogue with their tax and estate professionals about whether any (and what) action could be taken in 2021.

Your F.L.Putnam client advisor can help you frame the discussion and indicate areas of the proposals that will affect you and your family. Our team of financial planners stands ready as changes are codified and they continue to help our clients seek to manage taxation in the years to come.