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The Build Back Better Act Tax Proposals

As many of you know, the Biden Administration and Democrat-controlled Congress has proposed a sweeping $3.5 trillion 10-year legislative spending plan, commonly referred to as the Build Back Better Act. These are proposals and not yet law, but here is a summary so you can consider how they may affect your financial objectives and start preparing for change while there is still an opportunity to do so.

The Administration and Congress are hoping to pass the bill under budget reconciliation rules, which will allow the bill to pass the Senate and House with mere majority votes and bypass Republican opposition. Reconciliation rules require revenue-raising measures that will pay for the expenditures.

The House version of these measures has recently been released. *Remember, these are proposals and not yet law*. The Senate may or may not adopt the House version. Some proposals will pass, others will not, and still others will be modified. However, many tax professionals and Washington commentators believe that change is coming, and Democrats are keen to pass a bill before year-end, and certainly before 2022 mid-term elections, while they still command a majority in the House and Senate. The only question is to what extent change will happen. The general trend, however, seems quite evident from these proposals. Whatever ultimately passes will significantly impact our high-income, high-net-worth and small-business owner clients.

We wanted to briefly summarize some of the proposals that we believe will impact our clients so you can consider how they affect your financial objectives and start preparing for change while there is still an opportunity to do so. Your Security Mutual life insurance advisor stands ready to assist you and to coordinate with your tax and legal advisors.

Many of these provisions are projected to be effective on January 1, 2022. Those that may have a different effective date are noted below.

Income Taxes

Income Tax Rates: The top marginal income tax rate will be 39.6 percent for individuals earning more than $400,000 or married couples filing jointly ("MFJ") earning more than $450,000. Taxpayers who are currently in the $400,000 to $500,000 income range will be impacted the most, moving from the current 35 percent tax bracket to the 39.6 percent bracket.

Potential Action Steps >>>>

If possible, accelerate income into 2021 to take advantage of lower income tax rates. Consider delaying charitable contributions and other actions that may yield more effective tax deductions in 2022.

Consider maximizing contributions to employer-sponsored retirement plans in 2022 if you're not doing so today. Explore establishing a nonqualified deferred compensation plan with your employer. Both may reduce taxable compensation.

Small-business owners that offer a qualified retirement plan to employees should review their plans to ensure that they are offering themselves and their executives and high-income key employees the best possible income deferral and retirement outcome. Business owners without a retirement plan should consider implementing one for 2022 so that they can minimize taxable income into the future while building up retirement savings.

Capital Gains Tax: The top capital gains tax rate will be increased from 20 percent to 25 percent, impacting those in the upper income ranges mentioned above ($400,000 single; $450,000 MFJ). Today, singles earning up to $445,000 and MFJ earning up to $501,000 - pay only 15 percent capital gains tax. Note that the effective date of this provision is proposed to be the date of announcement, which was September 13, 2021. Thus, capital assets sold through the end of the year will NOT enjoy the lower current rates.

Potential Action Steps >>>>

Because the effective date of this provision is already upon us, even though the proposed bill has not become law, theoretically, it's already too late to take capital gains at the lower 2021 rates. However, because this is just a proposal, taking capital gains through the end of the year may be a bet that the final bill will have an effective date of January 1, 2022, similar to most of the other provisions.

Other considerations would be to implement tax-managed investment portfolios to minimize capital gains. Invest in cash value life insurance and non-qualified annuities to obtain tax-deferred growth and potential tax-free distributions through loans, withdrawals, accelerated benefits riders and lifetime income riders.

Net Investment Income Tax (NIIT): The NIIT (also known as the Medicare Surtax) of 3.8 percent generally applies to passive investment income. However, the proposed bill would expand the NIIT to cover net income derived from ownership in an S corporation, which normally avoids payroll taxes and self-employment taxes. The bill creates a new category of Specified Net Income ("SNI") such that the greater of a taxpayer's net investment income or SNI will be subject to the surtax. The surtax would apply to taxpayers with greater than $400,000 in taxable income (single) or $500,000 (MFJ).

Potential Action Steps >>>>

Work with your tax advisor to determine methods to minimize SNI, which may include a determination of the optimal mix of earned income and qualified retirement plan savings to reduce taxable income and the impact of SNI.

Ultra-High Income Surcharge: A new 3 percent surcharge is placed on those taxpayers, whether single or MFJ, with modified adjusted gross incomes ("MAGI") above $5 million. Even if earned income falls below that threshold, the sale of large capital assets generating capital gains may trigger the surcharge. Similarly, the distribution of large IRAs may also trigger the surcharge.

Potential Action Steps >>>>

Manage the sale of highly appreciated and high value assets to avoid excess capital gains that may drive up MAGI. Manage distributions from inherited IRAs to avoid exceeding MAGI limits.

Explore measures to reduce MAGI, including qualified retirement plans, particularly defined benefit pension plans and non-qualified deferred compensation plans.

Qualified Business Income Deduction: The Tax Cuts and Jobs Act of 2017 dropped the corporate level tax rate to a flat 21 percent. To address apparent inequity towards pass-through entity owners such as S corporation shareholders and Limited Liability Company members, this deduction, also known as the QBI or 199A Deduction, was enacted to provide a deduction of up to 20 percent of income subject to income limitations. President Biden campaigned for the elimination of this deduction. The proposed bill, however, does not eliminate it, but simply caps the maximum amount of the deduction to $400,000 for singles and $500,000 for MFJ.

Estate and Gift Taxes

Estate and Gift Tax Exemption: The Tax Cuts and Jobs Act of 2017 doubled the estate and gift tax exemption amount from $5 million to $10 million per person, plus inflation adjustments. Under that Act, this doubling of the exemption was intended to sunset at the end of 2025. Under the proposed bill, the sunset will be accelerated to the end of 2021, such that on January 1, 2022, the exemption amount will be back to $5 million plus inflation adjustments. Prior to this proposal, there were discussions to lower the estate tax exemption down to $3.5 million and the gift tax exemption down to $1.0 million. The proposals do not change the top tax rate of 40 percent.

Potential Action Steps >>>>

The current exemption, with inflation adjustments, is $11.7 million per person. Married couples can give away up to $23.4 million. Use as much of the exemption as possible through gifting before year-end to fund various estate tax planning strategies, such as funding ILITs and other grantor trusts (see below).

Step-Up in Basis: The tax basis of assets is stepped up (or down) to the value of the asset on the date of death. This concept, which has been well-ingrained in estate tax law, allows heirs to avoid capital gains tax if they decide to sell the asset shortly after inheriting it. While there was a lot of discussion and campaigning to eliminate the step-up in basis rule, the proposed bill does NOT address it.

Grantor Trusts: The proposals eliminate the use of grantor trusts prospectively. Existing grantor trusts are grandfathered. However, grandfathered status may be partially lost if there are additional contributions made to the grantor trusts after the effective date of the bill.

Grantor trusts are important estate-planning techniques that allow a person to transfer assets out of their estate while still being considered the owner for income tax purposes. This basically allows the asset to grow income tax-free inside of the trust. Under the proposed bill, that advantage will no longer be allowed, causing all of the assets to be included in the estate for estate tax purposes. The effective date for the grantor trust proposals will be the date of enactment of the law.

Almost all Irrevocable Life Insurance Trusts ("ILITs") are grantor trusts. Life insurance held in an ILIT has traditionally been one of the easiest ways to address a potential estate tax exposure. Existing trusts will need to be funded in alternative ways to avoid loss of grandfathered status. New trusts will need to be designed to avoid grantor trust status and be funded in ways to avoid estate inclusion and to deal with more limited gifting capacity.

Grantor Retained Annuity Trusts ("GRATs") are also grantor trusts. These trusts, extremely popular in a low interest rate environment, are typically designed to move the growth of rapidly appreciating assets to heirs out of the estate, with minimal impact on gift taxes. Under the proposed bill, GRATs may no longer be viable strategies.

Other grantor trust strategies such as Spousal Lifetime Access Trusts ("SLATs") and Qualified Personal Residence Trusts ("QPRTs") may also no longer be viable strategies once the proposed bill is enacted.

Potential Action Steps >>>>

If you are a candidate for one or more of these trusts and have been waiting to see where the political winds blow, time may be running out. You may wish to consider creating these grantor trusts as quickly as possible and fund the trusts with your current estate and gift tax exemption amount of $11.7 million per person to enjoy grandfathered status.

For existing ILITs or new ILITs created prior to the enactment of the new law, consider making large gifts of cash now to fund the trusts. The trusts will now have sufficient cash to pay ongoing premiums. Alternatively, the trust can purchase life insurance using single-premium designs or take advantage of premium deposit accounts, such as Security Mutual's Premiums Paid-in-Advance account, which allows the trust to deposit a lump sum with Security Mutual to pay future premiums. This may help to prevent loss of grandfathered status.

Explore the use of premium financing and split dollar for further funding of your existing ILITs to avoid loss of grandfathered status.

Retirement Plans

Roth Conversions: Converting a Traditional IRA to a Roth IRA is a popular planning technique for those who believe future income tax rates during retirement will be higher than they currently are. A Roth conversion requires paying the income tax now, upon conversion, so that future distributions from the IRA will be made tax-free. The proposed bill, however, would eliminate the ability of high-income earners to do a Roth conversion of their IRAs or employer-sponsored retirement plans (e.g., 401(k) plan). The thresholds are $400,000 of taxable income for single taxpayers and $450,000 for MFJ.

The effective date of this proposal is after December 31, 2031. The 10-year forward effective date exists to encourage Roth conversions during the next 10 years to raise tax revenue.

Potential Action Steps >>>>

If you're a high-income taxpayer, as defined by the proposed bill, you have 10 years to determine if a Roth conversion makes sense for your situation. Of course, you can institute measures to reduce taxable income to fall under the income thresholds, such as maximum contributions into employer-sponsored retirement plans and non-qualified deferred compensation plans.

In addition, the proposed bill would prohibit Roth conversions of all after-tax contributions to Traditional IRAs or employer-sponsored retirement plans, regardless of income level. This provision would effectively end the "Backdoor Roth IRA" concept where individuals who were unable to contribute to a Roth IRA because of income limitations would make after-tax contributions to a Traditional IRA, which is not subject to income limitations, and then convert that after-tax contribution to a Roth IRA. These provisions are effective for tax years after December 31, 2021.

Potential Action Steps >>>>

Determine if a Backdoor Roth IRA or Roth conversion of after-tax contributions make sense for your situation and implement it before the end of the year.

Contribution Limits: The proposed bill would prohibit further contributions to a Traditional or Roth IRA if the individual's aggregate totals of IRAs and defined contribution retirement accounts exceed $10 million as of the end of the prior taxable year. This limitation would apply only to taxpayers who have taxable income exceeding $400,000 for singles and $450,000 for MFJ.

Potential Action Steps >>>>

Reduce taxable income below the threshold amounts through the use of qualified retirement plans and nonqualified deferred compensation plans.

Required Minimum Distributions for Mega Accounts: For taxpayers who have taxable income above $400,000 for single and $450,000 for MFJ, and total retirement accounts valued at over $10 million, regardless of age, the proposed bill mandates a minimum distribution of 50 percent of the amount exceeding $10 million, but less than $20 million, and a minimum distribution of 100 percent of the amount over $20 million. The effect is to cap aggregate retirement savings to a total of $20 million. For younger wealthy taxpayers under the age of 59½, the 10 percent early withdrawal penalty will not apply to these distributions. In addition, the proposed law provides that these minimum distributions must first be satisfied from Roth IRAs, then Roth 401(k) account balances. Only when these accounts are depleted may the distributions be satisfied from pre-tax accounts.

Potential Action Steps >>>>

Reduce taxable income below the threshold amounts through the use of qualified retirement plans and nonqualified deferred compensation plans.

Corporate Tax

Corporate Tax Rate: The top corporate tax rate will increase to 26.5 percent for those corporations with taxable income over $5 million. A new lower 18 percent rate will be in effect for smaller corporations with taxable income under $400,000. All other corporations will be taxed at the current 21 percent.

Potential Action Steps >>>>

Work with your tax and legal advisor to determine if your current business entity structure is the most effective for your situation. The numerous changes proposed for higher individual income tax rates, wider application of the net investment income tax, caps on the QBI deduction, and more require determining whether operating as a C corporation rather than a pass-through entity would be more beneficial.

Conclusion

The proposed legislation consists of thousands of pages, so the foregoing has been merely a simple summary of certain provisions in the proposed bill. There are numerous other provisions included in the proposed bill that may impact you. As a result, you must consult with your own tax and legal advisor to determine if they interpret the proposed bill in the same manner as we do, and to determine the impact, if any, of these proposals on your financial situation.

For More Information Contact:

Contact your Security Mutual life insurance advisor today to review all of your financial-planning goals and objectives and to get the process started.

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Life Insurance Company of New York."

"Tax-free distributions assume, among other things, that withdrawals do not exceed tax basis, the policy remains in force until death, and the policy is not at policy issue, and does not become post issue, a modified endowment contract (MEC). Distributions from a MEC may be subject to income tax and possible penalties. Please consult with your attorney or tax advisor before acting.

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If withdrawals are taken under one of the immediate annuity riders before the contract owner turns 59½ (or within five years from the date the annuity payments started or if the contract owner turned 59½ within such five-year period), a 10 percent penalty may be imposed.

A portion of each annuity payment will be considered taxable, and the remaining portion is a non-taxable return of the contract owner's investment in the contract. Once the investment in the contract is depleted, all remaining payments are fully taxable. If the contract is tax-qualified, generally all payments are fully taxable.

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