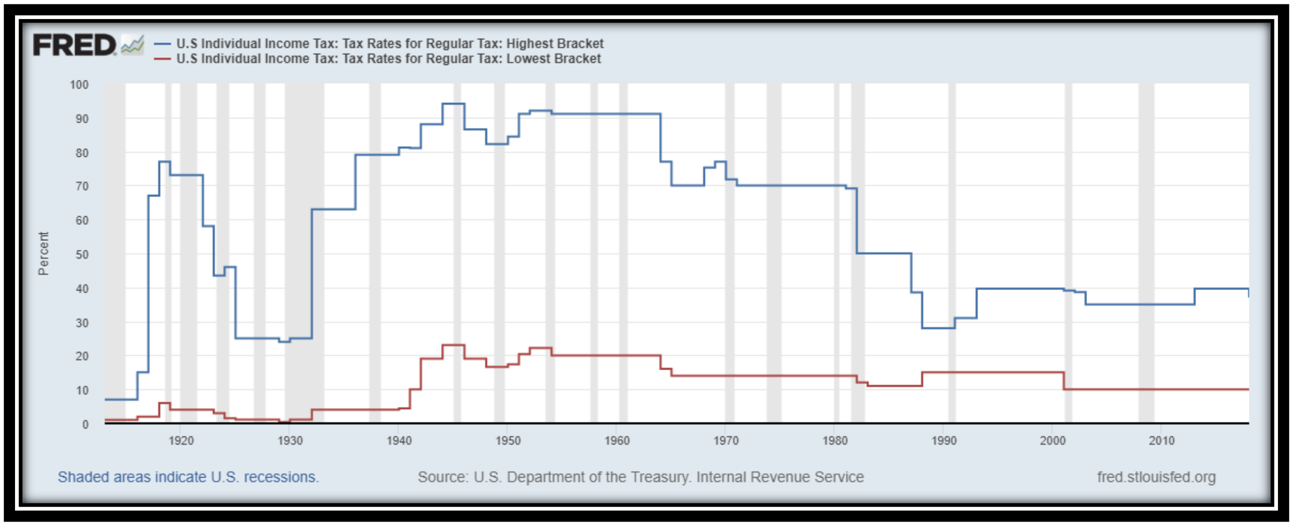
New Tax Law Legislation Podcast

Overview: since the 2020 election there has been a steady drumbeat surrounding substantive changes to existing tax policy. Like most other policy issues which define our times, taxation is a very contentious topic. There are those who believe it is necessary to balance the scales of income inequality and fund critical investment. Others view it as an expropriation by the state which tears at the very fabric of our capitalistic identity. While we certainly do not anticipate resolving this acrimonious debate in today's podcast, changes to the tax code date back to the founding of our fledgling republic. Abraham Lincoln enacted the first national income tax with the **Revenue Act of 1861**. It was designed to raise revenue in the north to fund the military needs of the Union Army. This nascent proposal imposed the first national income tax of **3%** on individuals with incomes above $800 (roughly $18,000 inflation adjusted). Given that there was not an efficient means to collect taxes, the Revenue Act of 1862 provided the encore which codified the first progressive income tax and established the agency we now call the Internal Revenue Service (National Constitution Center Staff, 2021). Over the ensuing decades there was a profusion of subsequent tax collection schemes and court challenges deciphering the constitutionality of these revenue measures. It wasn't until the **Sixteenth Amendment** was ratified in 1913, which vested the government with the power to establish a modern nationwide income tax on income from any source. With that, the old adage of "the rest is history" would seem like a fitting conclusion to our narrative, but this is Key Financial after all.

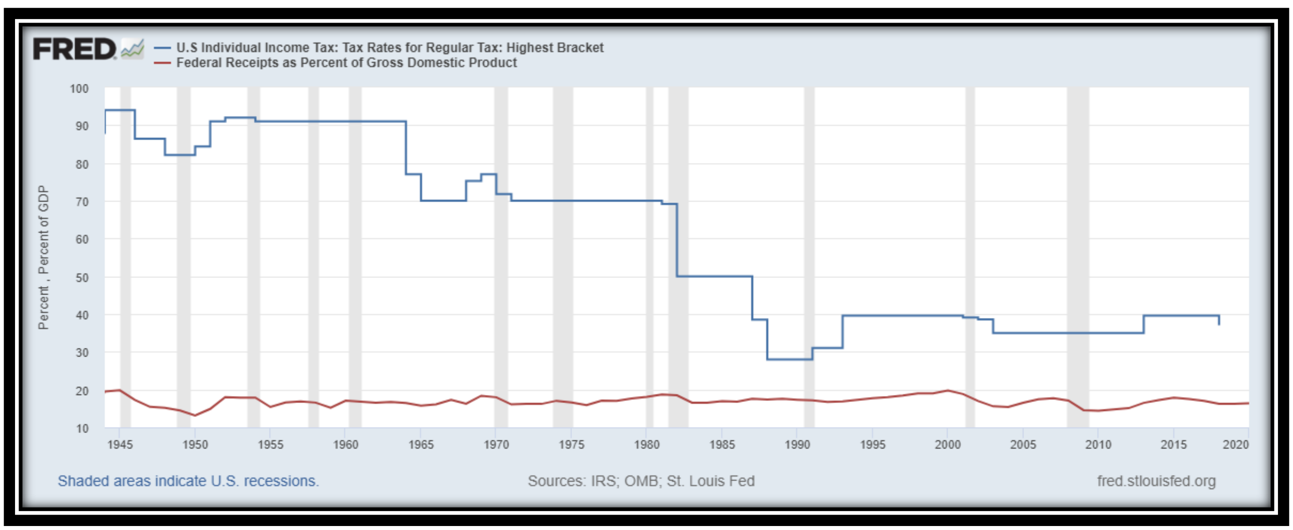
The two bodies within our legislative system overseeing these changes to the tax code are the very powerful Senate Finance Committee, and the House Ways and Means Committee. Each body has advanced dueling proposals throughout the year, yet several themes remain consistent with every iteration. Many of these changes relate to arcane areas of the tax code which are only intelligible by the most technically minded accountants and tax attorneys. For example, the debate over the Global Intangible Low Tax Income **(GILTI)** or Foreign Derived Intangible Income **(FDII)** systems bear little relevance to the lives of everyday Americans on mainstream. However, there are several targeted proposals which *will* affect the way we will save in the future, and the income taxes payable for high income earners and affluent households. The estate tax system is also looking at a major overhaul. These changes may ensnare more families and limit the planning techniques that have historically been utilized to maximize the transfer of wealth to the next generation. This segment is for those who desire an exposition of the proposed law, blended with an enlightened perspective of how financial planning can be an invaluable endeavor.

History of Highest & Lowest Rates Since Ratification of 16th Amendment



Source: St. Louis Federal Reserve. Illustrates historical changes of the top marginal tax rate and lowest market tax rate. The top marginal tax rate has fluctuated between 7% up to 92% since the ratification of the 16th Amendment in 1913.

Historical Relationship between top marginal tax rate and federal tax receipts as a proportion of output (Hauser's Law).



Source: St. Louis Federal Reserve. Illustrates changes in the top marginal tax rate and how federal receipts as a share of gross domestic product have changed. Despite significant swings in the top marginal tax rate, the government's overall share of output through federal tax receipts have remain largely unchanged. William Hauser observed that despite drastic changes in marginal tax rates, the federal tax revenues remain roughly 19.5% of GDP in the post WWII era.

Individual Income Tax Changes

Current	Proposed
Top Marginal Tax Rate = 37%	39.6% (return to pre-2018 levels)
Applies to Income > $628,301 (married) Applies to Income > $523,600 (single)	> $450,000 (married) > $400,000 (single)
Surtax on AGI > $5M (married) = None Surtax on AGI > $2.5M (single) = None Surtax on Estates & Trust = None	3% on AGI > $5M (married) 3% on AGI > $2.5M (single) 3% on income > $100,000 (estates/trusts)
Top Tax Rate 37%	42.6% (39.6% rate + 3% surtax if income > $5M/$2.5M)

Key Considerations:

- Many of the new provision applicable to high earners are applied to **adjusted gross income (AGI)**, which is calculated **prior** to deductions; therefore, various charitable techniques will not avoid the new taxes.

- These tax increases are applied before any Medicare or Net Investment Income taxes are calculated.

- Creates a great incentive to structure large transactions (e.g., asset or business sales) as installments over time. Maximizing retirement plans and non-qualified deferred compensation arrangements will also be key to lowering income and reducing current taxes.

Capital Gains & Qualified Dividends Rate Changes

Current	Proposed
Capital Gains Rates (single/married) Up to $40,400 / $80,800 = 0% $40,401 to $445,850 / $80,801-$501,600 = 15% Over $445,850 / Over $501,600 = 20%	Up to $40,400 / $80,800 = Same $40,401 to $400,000 / $80,801-$450,000 = 15% Over $400,000 / Over $450,000 = 25%
Top Capital Gains Rate 23.8%	31.8% (25% Cap gains rate+3.8% net investment income tax + 3% surtax if AGI > $5M/2.5M)
Net Investment Income Tax of 3.8% applied to **passive** investment income (interest, dividends, capital gains) when: MAGI > $250,000 (married) / $200,000 (single)	Expands the "definition" of net investment income to include income derived in the ordinary course of a trade or business. Applies on income exceeding $500K (married) / $400K (single) / Trusts & Estates

Key Considerations:

- New 25% rate will apply retroactively on gains and dividends paid after 09/13/2021. Written binding contracts in place before this date with no modifications are grandfathered.

- Even though the new rate goes in place right away the **realignment** of the tax bracket to $400,000 / $450,000 when this rate applies will not occur until 2022. Therefore, the higher income limits are still in place for the remainder of 2021.

- For decedent's dying in 2021, the estate should elect a fiscal year that extends well into 2022 to secure the current capital gains rate for as long as possible.

Estate and Gift Tax Changes

Current	Proposed
Estate Tax Exemption: $11.7M per person	$6M per person as of 01/01/2022 vs. 2025 (encourages usage now)
Valuation discounts for lack of control and marketability when transferring assets.	Barring valuation discounts (lack of control and marketability) for nonbusiness assets
Grantor Trusts: 1.) Assets are removed from taxable estate, but still taxable to the grantor for income tax purposes 2.) Sales to a grantor trust of appreciated property does not cause a taxable event.	1.) Assets held in a grantor trust will be added back to the taxable estate. 2.) Sales to a trust will trigger a taxable event.
Top tax rate on trust income is 37% on income > $13,051	Top tax rate of 39.6% will apply on trust income > $12,500, in addition to the 3.8% net investment income tax. Top tax rate will be 43.4%.

Key Considerations:

- Effective date for these provisions will apply after legislation is signed into law.
- Encourages the use of gifts and transfers now to use excess exemption
- Grantor trusts established prior to the law's passage will be grandfathered; however, **gifting assets to an exempt trust after the new law will cause a portion of the trust's assets to be included in grantor's estate** (e.g., gifting to an ILIT to cover insurance premiums).
- The portability of estate tax exemption between spouses will remain.

- Active business assets can still be discounted.
- The step-up on based on appreciated assets at death is still in effect.

IRA Rule Changes

Current	Proposed
Contributions permitted to an IRA if individual has earned income.	Contributions are barred if aggregate retirement accounts exceed \$10M and taxpayer income is > \$450,000 (married) / \$400,000 (single)
Minimum required distributions in the year the IRA owner reaches age 72.	Special distribution equal to 50% of the excess above \$10M & 100% distribution for any amounts exceeding \$20M. The 10 % early distribution penalty would not apply.
Rollovers & Conversion permitted with no restrictions. Certain types of investments are prohibited.	1.) Eliminate rollovers from traditional IRA to Roth IRA for those above income limits. 2.) Eliminate Roth conversions for IRAs and 401(K) plans if it includes nondeductible contributions (i.e., Back-door Roth). 3.) Conversions may only take place when taxpayer income is below thresholds. 4.) Eliminate IRAs from holding any entity which the account holder maintains a 10% ownership stake / accredited investor status. 5.) A 2-year transition period will apply to IRAs with prohibited investments.

Key Considerations:

- If IRA balance **exceeds** the new limits, **all Roth dollars** are required to be aggregated **FIRST** and then distributed. Pre-tax balances are secondary for special RMD*.*
- New law aggregates all traditional IRA, Roth, and qualified retirement accounts (e.g., 401(K)). Employers will be required to report any employer defined contribution plans with aggregate balances > \$2.5M annually to IRS. Contribution

restrictions for aggregation purposes would **only apply to IRAs** with no contribution restrictions to an employer 401(K) plan.

- A new 35% withholding requirement would apply to mandated distributions on large IRA's > $10M, but not 10% penalty.

Retirement Account Rules

Current	Proposed
Minimum required distributions begin at age 72	Age 73 starting in 2022 Age 74 stating in 2029 Age 75 starting in 2032
Catch up contribution over age 50 is $6,500 for employer plan and $3,000 for SIMPLE IRA $3,000	1.) Increasing catch-up for those between **62** and **64** to $10,000 for employer plans and $5,000 for SIMPLE IRA. 2.) Requiring qualified plans to designate catch-up contributions as **Roth** contributions.
Employer matching goes to pre-tax account	1.) Allowing participants to designate **matching** contributions as Roth contributions. 2.) Allowing plans to treat **student-loan payments** as **elective deferrals** for making matching contributions.

Key Considerations:

- These provisions are related to the "Securing a Strong Retirement Act" which was garnered a unanimous vote out of the House Ways and Means Committee on 05/05/2021. The goal is to secure passage of this law before yearend.

- Senate version of the bill pushes new RMD rule to age 75 starting in 2032.

New Loss Rules

Current	Proposed
Personal casualty losses – deductions are only permitted if attributable to federally declared disaster area.	Expansion to include losses attributable to theft, and many of natural disasters which are not declared a federal disaster. This is retroactive to events from December 31, 2017.
Worthless securities – IRS recommends investors account for worthless security as if they had been disposed on the **last day** of the tax year. Losses are classified as short-term or long-term depending on holding period which uses the end of the tax year.	The loss arises **at the time** of an identifiable event to establish worthlessness vs. end of year.

Notable omissions from proposal:

- No relief from the cap on local and state tax deductions presently capped at $10K.
- No repeal of the step-up in basis rule.
- No repeal of like-kind exchanges.

Possible additions:

- 2% excise tax on stock buybacks. May encourage more reinvestment of cash flows or dividend payments to return excess cash to shareholders.

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