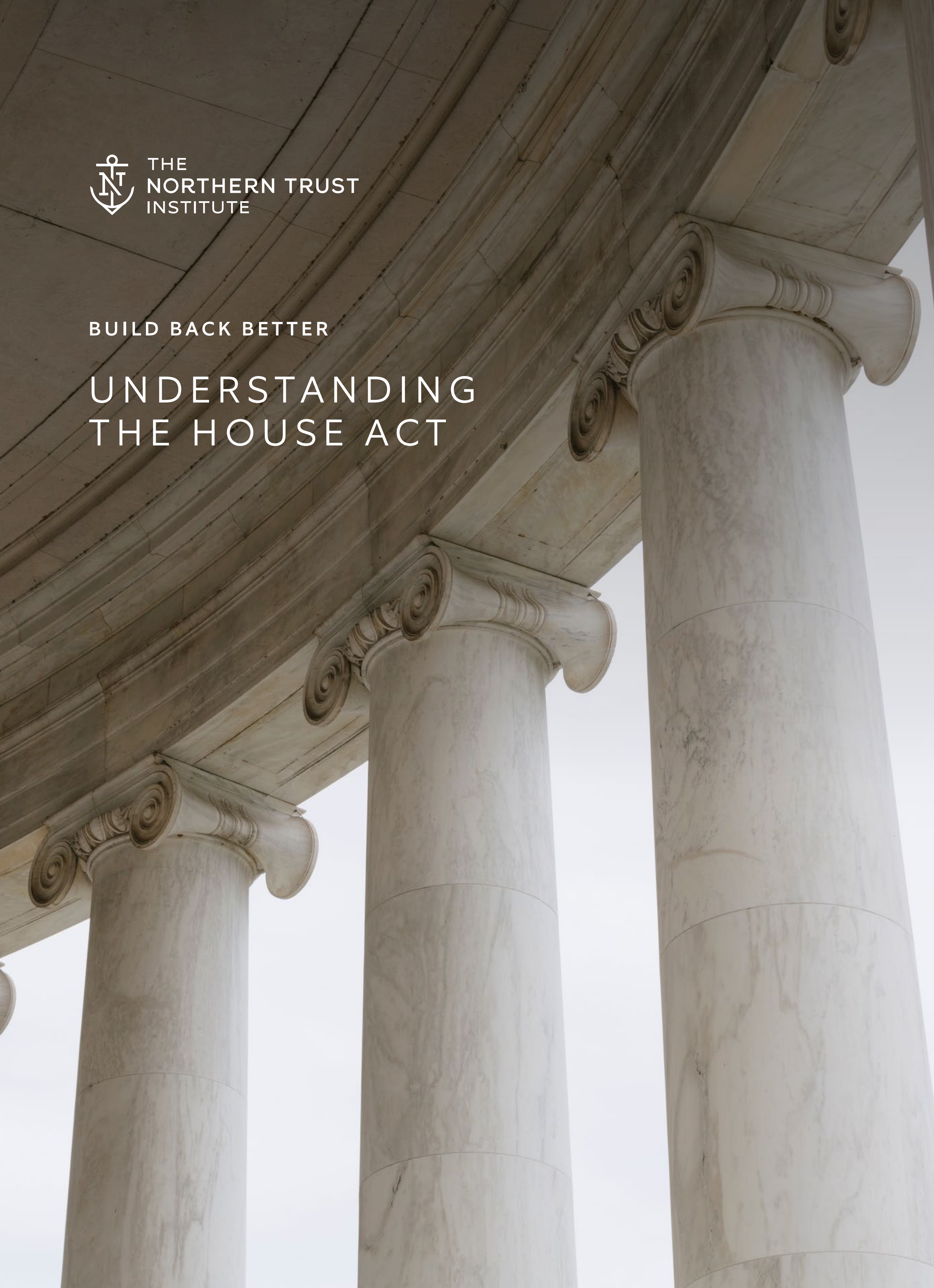


THE NORTHERN TRUST INSTITUTE

BUILD BACK BETTER

UNDERSTANDING THE HOUSE ACT

The House of Representatives passed the Build Back Better Act ("the Act"), the second component of the White House's ambitious spending plan, Friday, November 19. With a total of $1.75 trillion in new spending, the Act includes provisions for a wide range of social programs and other administration priorities.

If passed into law, the Act would be funded with investments designed to support IRS enforcement as well as several new taxes, including:

Imposing a surcharge of up to 8% on individuals, trusts and estates	Limiting excess business losses of noncorporate taxpayers	Limiting the qualified small business stock (QSBS) exclusion to 50% for most sales of QSBS after September 13, 2021
Expanding the 3.8% net investment income (NII) tax	Implementing restrictions on defined contribution retirement plans	Raising the $10,000 cap on the State and Local Tax (SALT) deduction to $80,000

Tap each measure for more details, our take and opportunities for action

Throughout the last year, the White House and Congressional Democrats proposed several other significant tax changes that, notably, are not included in the Act, such as:

Increasing the top individual income and capital gains tax rates	Reducing the gift and estate tax exemption to $5 million	Limiting the use of grantor trusts in several estate planning strategies
Implementing a billionaire income tax	Eliminating the step-up in basis at death	

The Act now moves to the Senate, where it faces an uncertain future. Any revisions made in the Senate would need to be passed in the House, with this cycle repeating until both sides are in agreement. Until the Act is passed by both the House and Senate, no tax changes should be considered completely "off the table."

Our advice continues to center on established best practices for building a plan to achieve your goals across a range of outcomes. If doing so is in line with your goals, consider utilizing your full estate tax exemption to transfer future appreciation out of your estate. This continues to be good advice, even if the exemption is not cut in half next year, as it is due to expire in 2026, and inflation-adjusted exemption amounts for 2022 will allow couples who have already maxed out their lifetime gifts to transfer another $720,000 next year. Additionally, when gifting to trusts, ensure current and new trusts are drafted to reflect your goals and wishes while providing maximum flexibility.

Ultimately, with an evenly divided Senate, all 50 Democratic members must vote for the Act in order for it to pass through the budget reconciliation process. The Act could also face several legal and procedural hurdles.

BUILD BACK BETTER AT A GLANCE

Total New Spending in House Act

$1.75T

Original New Spending Proposed by the White House in Early 2021

$3.5T

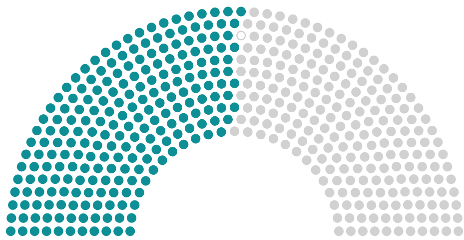
How the House Voted

220

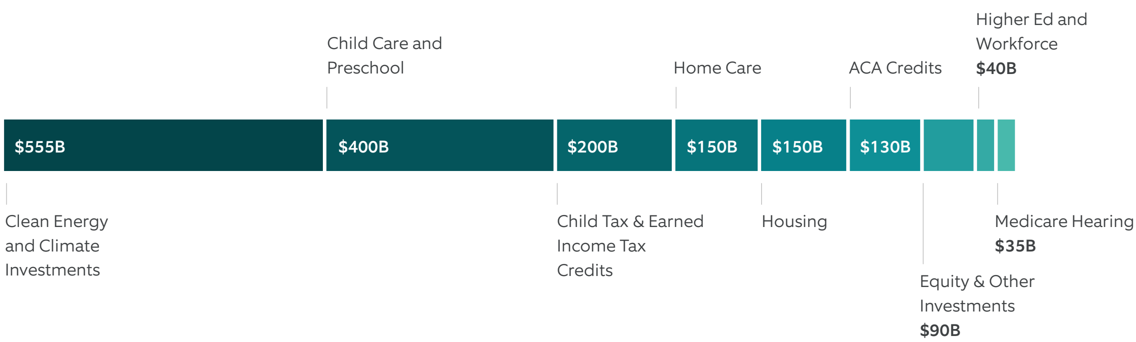
Members Voted **Yes**

213

Members Voted **No**



Spending Measures Included in House Act



DIVE DEEPER

On the following pages, we discuss the most significant tax changes in the Act, provide analysis surrounding their impacts and offer corresponding wealth planning strategies.

SURCHARGE ON INDIVIDUALS, TRUSTS AND ESTATES

TAX CHANGE	APPLIES TO
5% surcharge	• Individuals with modified adjusted gross income (MAGI) exceeding \$10 million (\$5 million if married filing separately) • Trusts and estates with MAGI exceeding \$200,000
Additional 3% surcharge (8% total)	• Individuals with MAGI exceeding \$25 million (\$12.5 million if married filing separately) • Trusts and estates with MAGI exceeding \$500,000

Applicable to taxable years beginning after December 31, 2021

Our Take

Among the most significant provisions in the Act is a new broad-based surcharge, which applies a 5% tax on an individual's MAGI exceeding $10 million and rises to 8% on income exceeding $25 million. The surcharge also applies to trusts and estates, imposing a 5% tax on MAGI above $200,000 and an 8% tax on MAGI above $500,000.

For individuals, MAGI is calculated by adding back certain deductions, including charitable deductions. Therefore, while there may be opportunities to smooth income to remain under the MAGI thresholds, contributions to charity do not reduce MAGI and will not be helpful in smoothing income.

Trusts are subject to the surcharge at a much lower MAGI threshold than individuals. This represents a potentially valuable opportunity for trusts that allow for distributions to beneficiaries who may not hit the individual thresholds. MAGI is calculated after taking into account distributions made to beneficiaries, including charitable beneficiaries. It is important to model whether accumulating income in the trust, allowing assets to grow outside of the beneficiaries' estate for estate and generation-skipping transfer (GST) tax purposes, outweighs the potential savings from the annual income tax arbitrage of avoiding the surcharge.

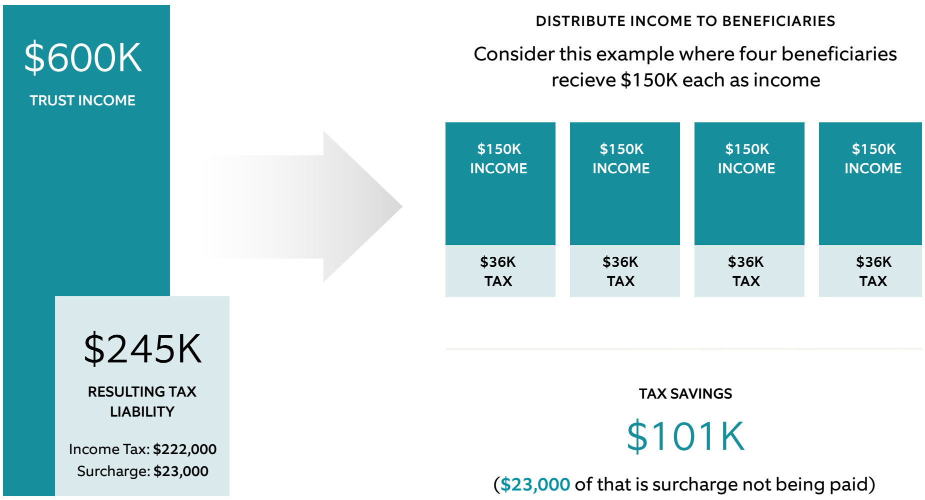
We also note that it appears as if grantor trusts will continue to be disregarded for income tax purposes and, therefore, income from grantor trusts should be subject to the higher MAGI thresholds applicable to individuals.

Opportunities to Mitigate the Surcharge

- For individuals, explore income smoothing strategies to manage tax brackets, making sure to exclude charitable deductions from the equation. Where possible, accelerate income and sales into this year (2021).
- When dealing with taxable non-grantor trusts, consider:
  - Distributing income to beneficiaries if permitted under the trust agreement. Trustees should model federal and state tax implications for beneficiaries and long-term estate and GST implications for the family. (See Figure 1)
  - Making distributions to charity which must be specifically permitted under the trust agreement to qualify for the unlimited charitable contribution.
  - Reallocating investments in the trust toward tax-free bonds.
  - Assessing the opportunity to sever the trust if permitted under the trust's terms.

FIGURE 1: DISTRIBUTING NON-GRANTOR TRUST INCOME TO BENEFICIARIES

Given the higher thresholds at which the surcharge would apply to individual income compared to trusts, it may be advantageous to make larger distributions to trust beneficiaries.



For illustrative purposes only. The chart assumes that (1) no deductions, credits, or other income offsets would impact the taxable income, (2) all income is taxable at ordinary tax rates, (3) if the income were held in the trust it would be subject to the highest income tax rate of 37%, plus the 5% surcharge on income over $200,000, and 3% on income over $500,000, (4) if the trust distributed out all income to four beneficiaries equally, the beneficiaries have no other sources of income and the whole amount is taxed at 24% without the imposition of a surcharge, and (5) the 3.8% NIIT is not included.

- When drafting new trusts, consider:
  - Providing the trustee with broad discretion to make distributions to a wider class of beneficiaries to spread income.
  - Determining if the applicable Principal and Income Act and state rules will allow capital gains to be treated as income (distributable) rather than principal (and not distributable).
- Creating a beneficiary deemed owner trust (BDOT), giving beneficiaries special withdrawal powers which are taxed to the beneficiary rather than the trust.

BUSINESS LOSSES OF NONCORPORATE TAXPAYERS

TAX CHANGE	APPLIES TO
Makes the disallowance of excess business losses (with provision for carryovers) for non-corporate taxpayers permanent	Business losses in excess of $250,000 for individuals ($500,000 for joint filers), adjusted for inflation ($262,000/$524,000)
Beneficiaries now succeed to carryovers of excess business losses from terminating estates and trusts	Beneficiaries of terminating estates and trusts that are carrying over excess business losses (such carryover will be allowed as a deduction)
Retroactively effective after December 31, 2020	

Our Take

While disallowance of excess business losses for noncorporate taxpayers was enacted with the Tax Cuts and Jobs Act in 2017, the CARES Act retroactively postponed the limitation for the 2018, 2019 and 2020 tax years, and the American Rescue Plan Act extended the sunset of the disallowance to January 1, 2027. Under the Act, excess business losses are permanently disallowed. Taxpayers are permitted to carryover excess business losses to the following year, and now terminating estates and trusts can pass such carryovers to their beneficiaries.

Planning Opportunities

- Assess the timing of future deductions and business losses.

QUALIFIED SMALL BUSINESS STOCK EXCLUSION

TAX CHANGE	APPLIES TO
Eliminates 75% and 100% exclusion rates for gains realized from qualified small business stock	• Individuals with income of $400,000 or greater • Trusts and estates (with no income threshold)
50% exclusion for gains realized from qualified small business stock	Remains intact for all taxpayers

Applicable to sales and exchanges after September 13, 2021 (unless a written binding contract is in effect as of September 12 provided that the contract is not modified thereafter in any material respect)

Our Take

The QSBS exclusion is a valuable tax planning strategy for long-term investors in certain small businesses that provides significant capital gains deferral for eligible gains. Although the baseline 50% exclusion remains available for all taxpayers, the 75% and 100% exclusion rates will not apply to taxpayers with AGI of $400,000 or greater.

Opportunities to Take Advantage of Losses

- If you currently hold QSBS eligible for capital gains deferral, assess the cash flow implications of the new law, and if feasible, consider spreading out the sale across multiple years with any other offsetting losses.
- Carefully coordinate with your tax advisor about your unique tax situation to ensure effective application of this rule.

NET INVESTMENT INCOME TAX

TAX CHANGE	APPLIES TO
Expansion of 3.8% tax	• Trade or business income for individuals with modified adjusted gross income (MAGI) exceeding $400,000 ($500,000 for joint filers) • Trusts and estates (regardless of income levels)

Applicable to taxable years beginning after December 31, 2021

Our Take

Today, trade or business income earned by an individual or non-grantor trust that materially participates in a business is not subject to the net investment income tax (NIIT). In the Act, this exception would be eliminated and net operating losses will no longer be accounted for in determining NIIT.

While individuals are already subject to the NIIT on investment income, this change brings the highest ordinary income rate to 40.8% for individuals with trade or business income.

Planning Opportunities

- Consider strategies for managing income thresholds such as maximizing contributions to IRAs, qualified retirement plans, and participating in nonqualified deferred compensation plans.

- Consider contributing assets to a charitable remainder trust (CRT), a tax exempt entity, to avoid, minimize or defer the NIIT. Although payments from a CRT shift the NIIT to the noncharitable beneficiary, CRT payments smooths out the NIIT passed through to such beneficiaries and subjects the NIIT to the higher MAGI thresholds applicable to individuals.

DEFINED CONTRIBUTION RETIREMENT PLAN RESTRICTIONS

TAX CHANGE	APPLIES TO
Restrictions on Roth conversions	• Taxpayers with AGI above $400,000 (or $450,000 for married filing jointly) are not permitted to make a Roth conversion • Roth conversions of defined contribution retirement plan funds are permitted only to the extent they are taxable
Restrictions on contributions to retirement accounts	Taxpayers with AGI above $400,000 /$450,000 may not contribute to a defined contribution retirement plan account (other than SEP and SIMPLE IRAs) if the aggregate value of their accounts is $10 million or more
New mandatory distributions from retirement accounts	• Taxpayers who are not permitted to make otherwise eligible contributions are now subject to minimum distribution of 50% of excess over $10 million • Such taxpayers are also subject to distributions of 100% of excess over $20 million, but only to the extent of Roth Accounts

- *No Roth conversions of after-tax portions of qualified retirement accounts after December 31, 2021*
- *No Roth conversions by high-income taxpayers after December 31, 2031*
- *Increased mandatory distributions from, and no contributions to, high balance defined contribution retirement accounts for high-income taxpayers after December 31, 2028*

Our Take

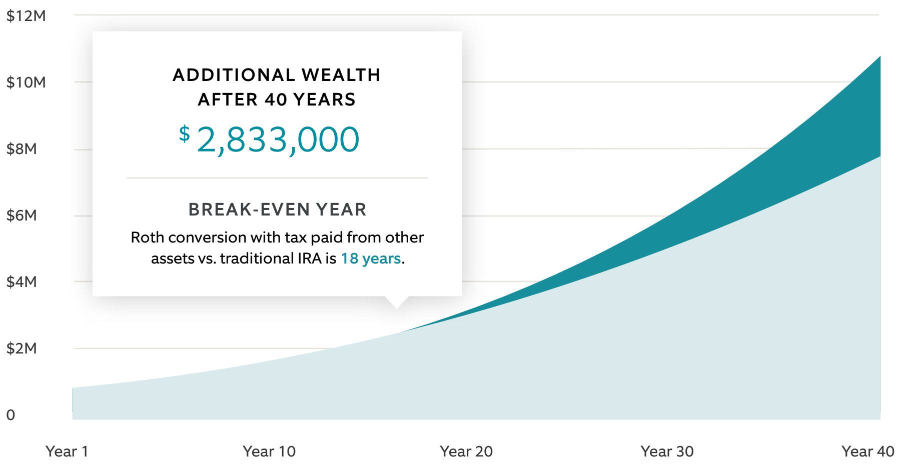
The purpose of these restrictions is to reduce the value of high-balance tax-advantaged defined contribution retirement plan accounts (including 401(k)s and IRAs) owned by high income taxpayers, and generally limit growth of Roth accounts. These changes greatly reduce eligibility for Roth conversions and operate on both the entry and exit points of certain retirement accounts owned by high income taxpayers. When the aggregated value of such taxpayer's retirement accounts exceeds $10 million, a portion of the excess must be distributed and no further contribution are allowed.

Planning Opportunities with Retirement Accounts

- Before the end of this year, those who have automated after-tax contributions to their employer plans should consider terminating such elections, as they will not be eligible for conversion to a Roth IRA.
- Those who expect high income beyond 2031 should consider whether and how to benefit from a Roth conversion prior to 2032. (See Figure 2)
- Individuals with overfunded retirement accounts should consider shifting investment strategies between their retirement and taxable accounts so that fast-growing equity interests are in taxable accounts and bonds are held in retirement accounts.

FIGURE 2: INCREASED NET PROCEEDS WITH ROTH CONVERSION

Comparing after-tax proceeds after 40 years assuming a constant tax rate of 37%.



NO ROTH CONVERSION
37% income tax in following years
$8,070,000
(IRA + $350,000 outside assets + growth)

ROTH CONVERSION
Tax paid from other assets
$10,903,000
(Roth IRA + $350,000 outside assets + growth)

STATE AND LOCAL TAX DEDUCTION

TAX CHANGE	APPLIES TO
Increases the SALT cap from $10,000 to $80,000 through 2031 ($40,000 if estate, trust, or married individual filing separate return)	Taxpayers that are subject to state and local taxes

Retroactively effective after December 31, 2020

Our Take

This Act seeks to undo the Tax Cuts and Jobs Act provision that capped the State and Local Tax (SALT) deduction at $10,000 for individuals, trusts and estates with a scheduled sunset in 2026. The Act cuts taxes significantly for the next five years by increasing the value of the deduction, but results in higher state and local tax bills in the following five years compared to if the cap expired altogether in 2026.

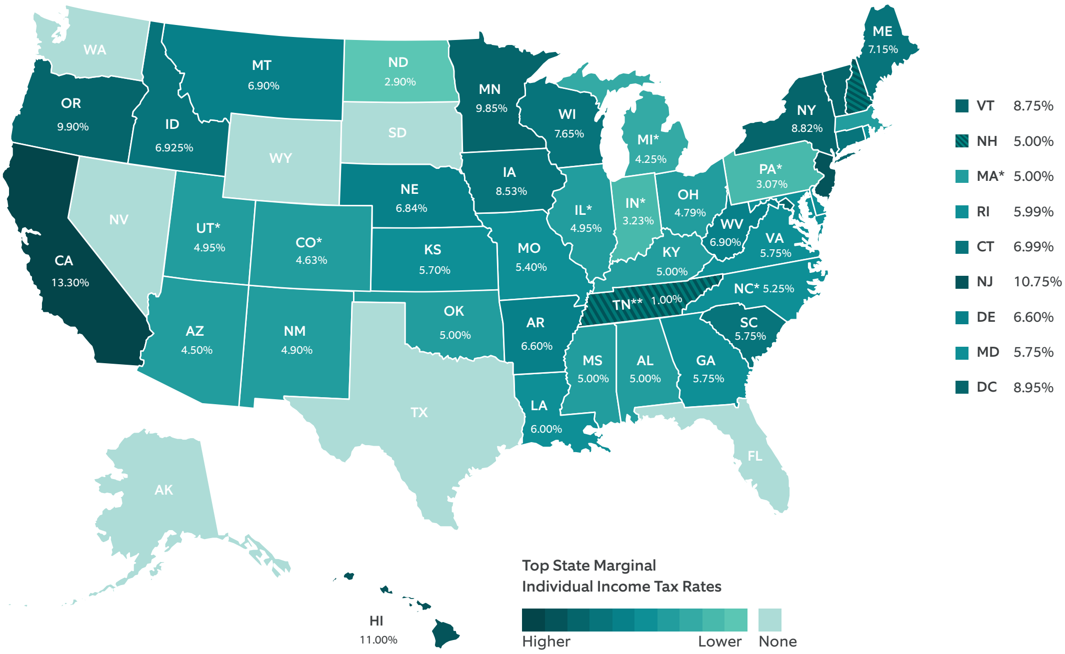
This provision could face significant opposition in the Senate where Democratic members are divided on inclusion of the deduction. A proposal to exempt individuals earning up to at least $400,000 is being considered, as well as a potential income cap for who can receive the deduction.

Planning Opportunities

If you are considering moving out of a high-tax state, work with your advisors to understand and prepare for the financial implications of your move. (See Figure 3)

FIGURE 3: HOW HIGH ARE TAX RATES IN YOUR STATE?

Top Marginal Individual Income Tax Rates by State, 2020.



Source: Tax Foundation and The Northern Trust Institute.

Does not reflect a comprehensive review of state tax policies.

Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rate, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included. (*) State has a flat income tax. (**) State only taxes interest and dividend income.

We continue to advise that it is far better to plan than predict, as the political environment suggests that some degree of change is probable. As such, we will continue to communicate the latest proposals and corresponding advice as developments merit.

ABOUT THE NORTHERN TRUST INSTITUTE

The Northern Trust Institute is a research center dedicated to advising affluent families. More than 175 experts collaborate across 34 areas of expertise to analyze behavioral patterns and identify the strategies that have been most effective for our clients — bringing the breadth and depth of our firm to each unique situation. The resulting insights position you to take action with confidence and achieve optimal outcomes with your wealth.

Disclosures

This document is a general communication being provided for informational and educational purposes only and is not meant to be taken as investment advice or a recommendation for any specific investment product or strategy. The information contained herein does not take your financial situation, investment objective or risk tolerance into consideration. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal, accounting or tax advice from their own counsel. Any examples are hypothetical and for illustration purposes only. All investments involve risk and can lose value, the market value and income from investments may fluctuate in amounts greater than the market. All information discussed herein is current only as of the date of publication and is subject to change at any time without notice. Forecasts may not be realized due to a multitude of factors, including but not limited to, changes in economic conditions, corporate profitability, geopolitical conditions or inflation. This material has been obtained from sources believed to be reliable, but its accuracy, completeness and interpretation cannot be guaranteed. Northern Trust and its affiliates may have positions in, and may effect transactions in, the markets, contracts and related investments described herein, which positions and transactions may be in addition to, or different from, those taken in connection with the investments described herein.

LEGAL, INVESTMENT AND TAX NOTICE. This information is not intended to be and should not be treated as legal, investment, accounting or tax advice.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Periods greater than one year are annualized except where indicated. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

THE NORTHERN TRUST INSTITUTE

Northern Trust
50 South La Salle Street
Chicago, Illinois 60603

(866) 296-1526