THE NORTHERN TRUST INSTITUTE

NAVIGATING POSSIBLE TAX POLICY CHANGES

INSIGHT AT THE INTERSECTION OF CHANGING TAX POLICY AND MANAGING COMPLEX WEALTH

Congressional debate continues to shape the form of potential tax policy changes designed to fund President Biden's proposed $3.5 trillion spending package. Most recently, House leaders released a new, "marked-up" version of the bill, now known as H.R. 5376.

While the proposals are far from being passed into law, this debate advances progress on a Democrat-only bill that could be enacted with a simple majority via the reconciliation process, which shields it from a filibuster. For the package to become law, however, all Democrats and independents caucusing with Democrats will need to hold together in an evenly divided Senate.

Although we continue to advise that it is far better to plan for, but not attempt to predict, potential tax policy changes, these insights provide an ever-more informed framework from which to incorporate flexibility into your plan and prepare for all outcomes.

ULTIMATELY, WE BELIEVE THE MOST LIKELY TAX CHANGES TO RESULT INCLUDE:

01

Raising the top individual ordinary income tax rate to 39.6% for those making more than $400,000

02

Increasing the capital gains rate from 20% to 25%

03

Replacing the flat corporate income tax rate of 21% with a graduated rate structure

While the political path forward for these and other proposed changes remains uncertain, it appears that some degree of change is probable. As such, we will continue to communicate on the latest proposals and corresponding advice as developments merit.

LIKELIHOOD OF POSSIBLE CHANGES

MOST LIKELY

Increase Top Individual Income Tax Rate to 39.6%

- Joint filers with $450,000+ taxable income
- Single filers with $400,000+ taxable income
- Estates and trusts with $12,500+ in taxable income
- Effective after December 31, 2021

Increase Capital Gains Tax Rate to 25%

- Increase the capital gains rate to 25% from 20%
- Effective for sales as of September 13, 2021, unless binding contract as of September 13 and sale occurs by year-end

Corporate and Entity Taxes

- Impose graduated increase to corporate income tax rate
- Remove valuation discounts for non-business assets
- Limit maximum allowable individual deduction for qualified business income

LIKELY IN SOME FORM

Reduce Gift and Estate Tax Exemption to $5 Million

- Exclusion applies to each individual and is indexed to inflation
- To start January 1, 2022
- Tax rate increase not proposed

Grantor Trust Limitations

- Significantly limit the use of grantor trusts in several estate planning strategies
- Effective for new trusts, and contributions and sales to existing trusts, on or after date of enactment

Surcharge on Individuals, Trusts and Estates

Impose a tax equal to 3% of a taxpayer's modified adjusted gross income where income is $5,000,0000+ and for estates and trusts with income $100,000+

IRA Restrictions

- Prohibit individuals from making additional contributions to IRAs if the total value exceeds $10 million
- If IRA exceeds $10 million, at least 50% distributions are required
- End “backdoor Roth” conversion strategy

Increase Carried Interest Holding Period

- Increase the holding period from 3 years to 5 years for carried interest to be taxed at capital gains rates
- Effective after December 31, 2021

Modify State and Local Tax (SALT) Deduction

Undo or modify the $10,000 cap on the federal deduction for state and local taxes

LEAST LIKELY

Eliminate Basis Step-Up at Death

Eliminate step-up basis — the increase of an asset’s basis to the property's fair market value at the date of the previous owner's death — for gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions)

Reinstate Itemized Deduction, with Limitations

- Limit benefit of itemized deductions to 28% rate
- Reinstate Pease limitations for taxpayers with income greater than $400,000

Limit 1031 Exchanges

Eliminate the ability to defer capital gains tax on real estate exchanges for gains above $500,000

Legend: Proposed change by House of Representatives (light teal boxes) — Under discussion, not proposed by House (grey boxes)

MOST LIKELY CHANGES

In the following chart, we discuss the most likely potential tax changes, provide analysis surrounding their impacts and offer corresponding wealth planning strategies.

INDIVIDUAL INCOME TAX

CURRENT LAW

37% top individual ordinary income tax rate

PROPOSED CHANGE

Increase the top individual ordinary income tax rate to 39.6% for those making $400,000 or more

OUR TAKE

There is a significant probability that income tax rates will increase for those making more than $400,000, as rates are at historical lows. The proposed income tax increase is relatively small and would return the top rate to 2013-2017 levels.

OPPORTUNITIES FOR ACTION

- Identify areas to accelerate near-term income, and consider deferring deductions and bunching charitable deductions next year, when rates may increase.
- Consider IRA Roth conversions, while remaining mindful of potential new rules impacting retirement accounts, discussed below in IRA Restrictions.

LONG-TERM CAPITAL GAINS AND QUALIFIED DIVIDENDS

CURRENT LAW

The top rate is 20% for long-term capital gains and qualified dividends (+3.8% net investment income tax)

PROPOSED CHANGE

The proposal would increase the capital gains rate to 25% from 20%, effective for sales after September 12, 2021

OUR TAKE

As noted, the proposal would be effective for sales after September 12, 2021, unless the seller had a binding contract entered into before that date and the sale occurs by year-end. Significantly, the proposal cuts current 75% and 100% exclusion rates for qualified small business stock (QSBS, sec. 1202) gains for those earning more than $400,000. A baseline 50% exclusion, however, would remain available. Though we believe there is a chance the changes to sec. 1202 could be advanced, expect challenges to the constitutionality of such changes if they materially negate the tax benefit of existing incented investments.

OPPORTUNITIES FOR ACTION

- If passed as proposed, the opportunity to realize capital gains at the previous lower rate has passed. That said, it is worth reiterating that achieving your goals, rather than fluctuating tax laws, should drive planning decisions. If you need liquidity to fund short-term goals, consider lending alternatives or pairing sales with tax loss harvesting.

CORPORATE & ENTITY TAXES

Proposed by House Ways and Means Committee

CURRENT LAW

21% top corporate income tax rate

PROPOSED CHANGE

The proposal would replace the flat corporate income tax rate of 21% with a graduated rate structure

OUR TAKE

The proposed structure is 18% on the first $400,000 of income, 21% on income up to $5 million, and 26.5% on income thereafter, with the graduated rate phasing out for corporations making more than $10,000,000. Additional business-related proposals include:

- Limit the maximum allowable deduction for individuals for qualified business income to $500,000 for joint returns and $10,000 for trusts or estates
- Allow S-Corporations to reorganize as partnerships tax-free so long as the S-Corp was formed prior to May 13, 1996 and reorganizes by December 31, 2023
- Increase the estate tax special use valuation for real property used in a family farm or family business from $750,000 to $11,700,000
- As discussed in the Capital Gains section, the proposal cuts the exclusion percentage for gains realized from certain qualified small business stock (QSBS) under sec. 1202

Notably, the proposed corporate tax rate change is more modest than the original proposal, a flat 28% rate.

OPPORTUNITIES FOR ACTION

- Consider revisiting the entity structure of your business and family's business holdings. Model cash flow scenarios (C-Corp vs. pass-through vs. S-Corp), taking into account the cost and timing of converting, use of cash flows, and other tax implications (e.g., state and payroll taxes). Note that the proposal regarding S-Corps presents a unique window of opportunity to convert to partnerships where feasible.
- Review your business operations and workforce footprint to determine whether you might take advantage of new tax credits, if they become available.

CHANGES LIKELY IN SOME FORM

Despite the majority of the following tax changes being proposed by the House Ways and Means Committee, their political path forward remains uncertain in an evenly divided congress. That said, we believe that, ultimately, some versions of the proposed changes are likely to become law.

GIFT & ESTATE TAX (TRANSFER TAX)

CURRENT LAW

$11.7 million estate tax exemption, reverts to $5 million (inflation-adjusted) after 2025

PROPOSED CHANGE

The proposal would decrease the current exemption by half, reverting to $5 million per individual, indexed for inflation ($5.85 million)

OUR TAKE

The 40% rate did not change in the proposal, and retroactivity is not included. Note that under an additional proposal, taxpayers would no longer be permitted to utilize valuation discounts for transfer tax purposes when transferring entities holding non-business assets (passive assets not used in the active conduct of a trade or business). The removal of valuation discounts for non-business assets would have significant planning implications for families who hold assets in family limited partnerships and other pass-through entities.

If your taxable estate is above federal and/or state estate tax exemption amounts, understanding your estate tax liability is critical. Many people do not realize certain assets are included in their estate for estate tax purposes, such as individually owned life insurance. Also, numerous states have exemption amounts far below federal limits, so you may owe state estate tax and not be aware of it. If you are confident you have enough wealth to support your lifetime goals, various wealth transfer strategies can move excess wealth — and future growth on the assets you transfer — out of your taxable estate.

OPPORTUNITIES FOR ACTION

- Considering using the 2021 exemption to move assets out of your estate by end-of-year (or prior to enactment, if grantor trusts are utilized).
- Utilize valuation discounts for transfers prior to year-end where feasible and, going forward, consider revisiting the tax implications of how business interests and other assets are held across family limited partnerships and other passive entity structures.

SURCHARGE ON INDIVIDUALS, TRUSTS AND ESTATES

PROPOSED CHANGE

The proposal would impose a tax equal to 3% of a taxpayer's modified adjusted gross income over $5 million ($2.5 million for a married individual filing separately) or greater than $100,000 for estates and trusts, excluding charitable trusts. The change would be effective after December 31, 2021.

OUR TAKE

For those impacted, the change would bring the capital gain tax rate to 31.8%, including the 3.8% NIIT tax, and ordinary income rate to 46.4%. Note that, if enacted, the tax rates for non-grantor (taxable) trusts would generally be significantly higher if the trust accumulated the income, rather than distributing such income out to individual beneficiaries.

OPPORTUNITIES FOR ACTION

- Explore income smoothing strategies to manage tax brackets and, when dealing with taxable trusts, consider distributing such income out to beneficiaries.

CARRIED INTEREST

CURRENT LAW

Carried interest is taxed as capital gains

PROPOSED CHANGE

Increase holding period from 3 years to 5 years for carried interest to be taxed as capital gains (with exclusions for real property, trades or businesses and certain taxpayers)

OUR TAKE

The House proposal fell short of the Biden administration's initial proposal of taxing interest private equity managers earn from their investments as ordinary income. However, carried interest that does not meet the extended five year holding-period would be subject to the tax rate for ordinary income under the current proposal.

OPPORTUNITIES FOR ACTION

- Revisit the fee structure to account for after-tax returns.
- Consider creating co-investment vehicles to pool money from the firm's fund managers and other investors alongside the fund to continue to receive capital gain tax treatment under traditional shorter holding periods.
- Time charitable donations to minimize the tax impact of carried interest.

GRANTOR TRUST LIMITATION

PROPOSED CHANGE

The proposal would significantly limit the use of grantor trusts in several estate planning strategies, including grantor retained annuity trusts (GRATs), spousal lifetime access trusts (SLATs), individual life insurance trusts (ILITs), and intentionally defective grantor trusts (IDGTs). It might also apply to planning strategies involving beneficiary deemed owner trusts (BDOTs) and beneficiary defective inheritance trusts (BDITs).

OUR TAKE

This proposal could negate the value of the above-listed trust strategies, as any grantor trust formed on or after the date of enactment would eventually be subject to transfer taxes (estate or gift tax). In addition, any transfer of property between such trust and the grantor could be treated as a taxable sale for income tax purposes. Existing grantor trusts would be "grandfathered," but any portion attributable to a future contribution to such trust would not. What constitutes a future "contribution" has yet to be defined. For example, would the payment of the income taxes by the grantor, on behalf of the trust, be deemed a contribution to the trust? Would an asset swap? In addition, the new "marked-up" version of the house reconciliation bill (H.R. 5376) now indicates that a post-enactment date transaction (at least a sale or exchange) between a grantor and a grandfathered grantor trust would be a taxable event and that any in-kind distributions (including, even, an annuity from a GRAT) would likely be treated as realization events that trigger capital gain.

OPPORTUNITIES FOR ACTION

If you are confident that you can fund your lifetime goals and wish to minimize your taxable estate, consult your advisor about funding a grantor trust, with appropriate flexibility built-in through trust protectors and the ability to toggle grantor trust status, before the date of enactment. A pre-enactment date transaction between a grantor and a grantor trust appears, still, to be a non-taxable event.

RETIREMENT ACCOUNTS

Proposed by House Ways and Means Committee

PROPOSED CHANGES

- Prohibition on Roth conversions for taxpayers with AGI above $400,000 (or $450,000 for married filing jointly), effective 2032, and general prohibition on Roth conversion of amounts held in qualified retirement plans, except to the extent the conversion is taxable, effective 2022
- Prohibition on contributions to retirement accounts (other than SEP and SIMPLE IRAs) when the total value of all defined contribution accounts and IRAs (including inherited accounts) is $10M or more, but only for taxpayers with AGI above $400,000/450,000
- Mandatory distribution of 50% of excess over $10M and mandatory distribution of all excess over $20M to be paid exclusively from Roth accounts
- Preventing the purchase of interests in private placement investments. IRAs holding such investments will have until the start of 2024 to distribute or divest from such interests to avoid disqualification of the entire IRA holding the investment

OUR TAKE

These changes would quickly reduce the value of high-balance IRAs and accelerate tax revenues from taxable accounts. The prohibition on Roth conversions seeks to prevent "back-door" Roth IRA funding, including "Mega-back-door Roth IRAs," which use qualified plan accounts to purchase shares in one account and roll them to a Roth IRA prior to a big increase in value. As of the end of this year, all Roth conversions from qualified plan accounts will only be permitted to the extent they are taxable.

OPPORTUNITIES FOR ACTION

- Before the end of this year, those who have automated after-tax contributions to their employer plans should review these elections and terminate all after-tax contributions, in most cases. Those who expect high income beyond 2031 should consider whether and how to benefit from a Roth conversion prior to 2032.
- 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.
- Those who have private placement investments in their IRAs should begin the process of redeeming their interests.

SALT DEDUCTION

Not Proposed by House Ways and Means Committee

CURRENT LAW

The State and Local Tax (SALT) deduction was capped at $10,000 in 2017 and is scheduled to sunset in 2025

PROPOSED CHANGE

Though discussion of SALT was absent from the House Ways and Means Committee's tax draft, previous proposals advocated increasing the cap beyond $10,000. We expect discussion of SALT to continue as legislation works through Congress.

OUR TAKE

Several issues and conflicting priorities are at play as all levels of government work to address budget deficits. In particular, lawmakers in high-tax states are seeking a full restoration of the deduction to stem the steady flow of residents to lower-tax states. In typical legislative tug-of-war, one possible outcome could be something short of either a full restoration or repeal.

OPPORTUNITY FOR ACTION

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.

UNLIKELY CHANGES

The following tax proposals have been discussed previously by congress and the White House, but were not advanced in the House Ways and Means Committee's tax draft. While we believe these changes are unlikely to become law as part of the reconciliation package, it is possible that they could be revisited.

BASIS STEP-UP AT DEATH

CURRENT LAW

The cost basis of assets is "stepped-up" to fair market value as of date of death, resetting the tax basis to fair market value, in turn reducing capital gains taxes owed

PROPOSED CHANGE

The House Ways and Means Committee's tax draft did not address the basis step-up at death. In previous proposals, a realization of capital gains — in excess of $1 million per person — would be triggered upon transfer of appreciated assets at death or by gift, including transfers to and distributions from irrevocable trusts and partnerships. The proposal would provide certain protections for family-owned and operated businesses (which may or may not include farms), effective January 1, 2022.

Gains on unrealized appreciation would be recognized by a trust, partnership or other non-corporate entity if that property has not been the subject of a recognition event within the prior 90 years — with the first possible recognition event to take place on December 31, 2030. Under the proposal, gains at death could be paid over 15 years (unless the gain comes from liquid assets such as publicly traded securities). There would be no partial interest discount on any transfer nor gain recognition for transfers to spouses or charities at death.

OUR TAKE

Because any changes to this part of the tax code will be complex and difficult to execute, a total repeal of the rules, without substantial exemptions, is unlikely. Elimination of step-up in basis was tried before, in the 1970s, but was ultimately abandoned before implementation due to complexity.

OPPORTUNITIES FOR ACTION

- If the step-up in basis rules remain, consider maintaining low-basis assets in your estate, especially if your estate does not exceed the exemption amount and you are well into retirement.
- Work with your advisors to carefully analyze the viability of using the step-up in basis rules and the risk associated with continuing to hold low basis assets in a rising tax environment.
- Ensure trust vehicles incorporate flexibility to swap assets in and out of the trust depending on what is beneficial from an income tax standpoint once the final rules are structured.
- Make sure your assets are properly aligned with your goals. Under current law, low-basis assets are useful for both philanthropic and future wealth transfer goals. If the proposed change is passed, consider prioritizing philanthropic giving.

ITEMIZED DEDUCTIONS

CURRENT LAW

No cap on itemized deductions, Pease limit suspended through 2025, Cap on the State and Local Tax (SALT) deduction

PROPOSED CHANGE

Previous proposals have advocated capping value at 28% and reinstating the Pease limit for income greater than $400,000, but neither item was advanced in the House Ways and Means Committee's tax draft plan

OUR TAKE

Deferring deductions typically makes sense when they are more valuable to be used against higher rates. However, if these limitations were to go into effect, the result would mean taxpayers earning more than $400,000 with rates higher than 28% would face limited itemized deductions.

OPPORTUNITIES FOR ACTION

- Determine if it makes sense to accelerate charitable gifts in 2021 before any constraints on contributions take effect.
- Consider deduction of up to 100% of adjusted gross income for cash gifts to public charities under the CARES Act.

1031 EXCHANGES

Not Proposed by House Ways and Means Committee

CURRENT LAW

Defer capital-gains taxes on the sale of one property by reinvesting the proceeds in a similar property within 180 days

PROPOSED CHANGE

Minimize the benefit to only allow a deferral of $500,000 per year or $1 million if filing a joint return

OUR TAKE

The proposed tax change would potentially have a significant impact on families transitioning real estate assets, real estate investors reacting to an unsolicited offer or looking to retire with more passive assets, and business owners intending to use the proceeds from the sale of their business to build out a real estate portfolio. The current proposal would be effective January 1, 2022; however, it is unclear whether a taxpayer who enters into a 1031 transaction in 2021 but closes the transaction in 2022 would be subject to the new limitation.

OPPORTUNITIES FOR ACTION

Revisit your real estate holdings and investment plan:

- Understand the tax basis and hold period for each of your real estate investments.
- Identify legacy assets you are willing to hold indefinitely.
- Consider entering into a 1031 exchange transaction for low-performing or highly appreciated investment properties before year end (and ideally closing the transaction before year end if feasible).

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Northern Trust
50 South La Salle Street
Chicago, Illinois 60603

(866) 296-1526