Certified Public Accountants

Gatto McFerson

November 4, 2021

Dear Friends and Colleagues,

Taxpayers are breathing a sigh of relief as the proposed 2021 tax changes appear to be less onerous than once feared. Provisions that were causing panic in the streets last summer (increased capital gain rates, for example) have been either eliminated or trimmed back substantially.

As this legislation gets closer to President Biden's desk, here are the key areas to keep an eye on for tax planning purposes.

Changes to Top Income Tax Rate

Earlier in the year, the plan was to increase the top income tax rate from 37% to 39.6% for those with taxable incomes above $400,000. This has been dropped entirely from the most recent legislation. It appears ordinary income tax rates and their corresponding thresholds will remain the same.

Observation #1: Always remember, the taxable income rates and thresholds aren't all or nothing. You only pay tax at the higher rate on the income that exceeds the corresponding threshold.

Observation #2: Given that it now appears rates will remain the same next year, consider pushing income into 2022 and/or accelerating expenses in 2021.

Long-Term Capital Gains/Qualified Dividends

Earlier in the year, the plan was to tax capital gains and qualified dividends at ordinary income tax rates if the taxpayer's income was over $400,000, almost doubling the tax on this type of income. That idea has also been dropped entirely from the most recent legislation. It appears long-term capital gain rates will remain the same.

Observation #1: The rush to close a business sale by the end of the year has been greatly diminished. In fact, if capital gain rates do remain unchanged, then pushing a sale off to early 2022 might be the better play.

Observation #2: Given that it now appears rates will remain the same next year, consider pushing gains into 2022 and/or realizing losses in 2021.

Deductions on State and Local Taxes (SALT)

Currently, a total deduction of $10,000 is the maximum permitted for personal state income and home property taxes. This is a very low number for most taxpayers, but especially for those who live in states with high tax rates and/or high property values (like California).

Proposals are being considered to either suspend the $10,000 limitation for five years, or to increase the deduction amount to $72,500. Either would be a welcome change for those from high-tax states.

Observation #1: If your state income and property taxes will exceed $10,000 in 2021, push any additional payments into 2022…but only if you can do so without getting penalized. Chances are you'll receive some additional benefit from paying those taxes next year.

Observation #2: The current limitation on property taxes only relates to your personal residence(s). It does not apply to any rental property you might own.

Surcharge Tax on High Income Individuals

In the most recent draft of legislation, a 5% surcharge will be applied if a taxpayer's income exceeds $10 million dollars. An 8% percent surcharge will be applied if the income exceeds $25 million. This is clearly a tax targeting the very wealthy.

Observation #1: It is unclear whether income generated from the sale of a business would be included in this. It is possible that gains from the sale of a business, because it is typically a once-in-a-lifetime event for the taxpayer, would be excluded.

Qualified Business Income Deduction

Currently, individuals are allowed to deduct 20% of "qualified business income" (Section 199A) from a partnership, S corporation, or sole proprietorship. The deduction is disallowed for specified service trades or businesses with income above a certain threshold. Under the original Biden Proposal, those with taxable incomes over $400,000 would see a phase out of this qualified business income deduction. This provision has also been eliminated from the current legislation.

Observation #1: A pass-through entity is considered to be a sole proprietorship, an S-Corporation, or a partnership (LLC/LLP). Employees are not eligible.

1031 exchanges

There had been rumblings about restricting like-kind (1031) exchanges and limiting the amount of the gain deferred to $1 million. This has been eliminated from the most recent legislation.

Estate Tax

According to the recent draft legislation, there will be no reduction of the estate tax exemption from the current $11.7 million to $3.5 million. Also, there will be no changes to the stepped-up basis for appreciated assets in estates.

S-Corporation Taxation

This area appears to be the one bit of bad news. Currently, net income from an S Corporation is taxed using ordinary income tax rates, but it avoids the extra Net Investment Surtax of 3.8% that is charged on most investment and rental income. Under the proposed legislation, S Corporation income would be subject to this extra 3.8% tax for those with Adjusted Gross Incomes of $500,000 or more.

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Should you have any questions about the above, please feel free to contact our office at any time.

Sincerely,

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