KRAMER & JENSEN LLC
CERTIFIED PUBLIC ACCOUNTANTS

Contact Us:

Kramer & Jensen LLC
7430 E. Caley Ave. Suite 300E
Centennial, CO 80111
T 303-741-2253
F 855-330-4215
sjensen@kramerjensen.com

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35 Million: The Total Backlog of Tax Returns The IRS Had At The End Of Tax Season

The Internal Revenue Service has released a midyear report to Congress that details a significant backlog of tax returns dating back to the end of tax filing season, and many of those returns have yet to be processed. While backlogs are not unusual, this year's is far greater than in previous years.

That's bad news for those taxpayers who are eagerly waiting for tax refunds. For tax year 2020, roughly 70 percent of the individual returns that have already been processed have resulted in refunds being paid. Those refunds have averaged $2,827.00, but there were still more than 35 million returns for last year that had not yet been addressed by mid-May. An independent advocacy group within the IRS says that at the same point in time the previous year, there were a third the number of backlogged returns as now.

In writing the report, national taxpayer advocate Erin M. Collins said, "For taxpayers who can afford to wait, the best advice is to be patient and give the I.R.S. time to work through its processing backlog. But particularly for low-income taxpayers and small businesses operating on the margin, refund delays can impose significant financial hardships."

The agency issued a statement indicating that by June 18th, two months after the official filing deadline, almost seven million individual tax returns had been processed. Their work is ongoing continuously, addressing both current returns, those from previous years, and amended returns. More than twice that many are currently being processed.

Backlogs have been a problem in the past, but an evacuation order issued as a result of the pandemic kept IRS employees out of processing facilities, and that and the need to incorporate new tax legislation passed for the 2021 filing season has made things far worse. The agency was also responsible for sending out the third stimulus payment, bringing the total value of payments to $807 billion and the number processed over a 15-month period to 475 million.

While 2019 saw a backlog of 7.4 million returns at the close of tax filing season and 2020's backlog reached 10.7 million, 2021's 35 million return backlog has led to several recommendations and objectives being issued to improve things in the future.

A large number of tax returns were processed before the tax filing deadline, and of those 136 million returns, 96 million required that refunds totaling about $270 billion be paid. Both individual returns and business returns are included in the 35.3 million that still need to be processed, and those in the backlog all require additional intervention from an IRS employee in order to be processed.

The Treasury Green Book of Biden Proposed Tax

Changes

The U.S. Treasury has released the Biden administration's 2022 Fiscal Year Budget, which includes a general explanation of the administration's 2022 revenue proposals. The publication is commonly referred to as the **Green Book** and outlines the Biden administration's tax proposals. Keep in mind that these are proposals and will have to be passed by Congress. The Green Book proposals include both domestic and international taxes; however, this article will only cover domestic tax issues that deal with individuals and small businesses. Also included in the Green Book are proposals to extend, expand or create new energy-related tax credits; we have not included any of these proposals in this article.

Long-Term Capital Gains Rates

Currently, long-term capital gains and qualified dividends are taxed at the following rates.

CG TAX RATES BY AGI RANGE FOR 2021			
Filing Status	**Zero Rate**	**15% Rate**	**20% Rate**
Single	0 - $40,400	$40,401 – $445,850	$445,851 and above
Head of Household	0 - $54,100	$54,101 – $473,750	$473,751and above
Married Filing Joint	0 - $80,800	$80,801 – $501,600	$501,601 and above
Married Filing Separate	0 - $40,400	$40,401 – $250,800	$250,801 and above

The Green Book proposals would increase the tax rate for long-term capital gains and qualified dividends to 39.6% (the proposed increase to the top individual rate) from the current 20% rate to the extent the taxpayer's AGI exceeds $1 million. That will result in a tax as high of 43.4% when including the 3.8% net investment income tax imposed on investment income of middle- to higher-income taxpayers. The proposal suggests making the retroactive rate change effective for gains and income recognized after April 28, 2021.

***Example**: Under the proposal, a taxpayer with $900,000 of wage income and $200,000 of long-term capital gain income would have $100,000 of capital income taxed at the current preferential tax rate and $100,000 taxed at ordinary income tax rates.*

Top Individual Tax Rate

The Green Book proposes an increase in the top individual rate from the current 37% to 39.6%. This will return the top rate to where it was before the passage of the Tax Cuts and Jobs Act (TCJA). Note: under the TCJA, the 37% rate applies only through 2025. The table below shows the taxable income threshold for the top tax rate in 2021, and only income above that level is taxed at the top tax rate. Tax rate brackets are currently adjusted annually for inflation; the proposed 2022 thresholds will be inflation-indexed in future years.

TAXABLE INCOME THRESHOLD* FOR THE TOP INDIVIDUAL TAX BRACKET		
Filing Status	**2021**	**Proposed 2022**
Single	523,600	452,700
Head of Household	523,600	481,000
Married Filing Joint	628,300	509,300
Married Filing Separate	314,150	254,650
*top rate applies to taxable income above these amounts		

Pass-Through Income Subject to 3.8% NIIT or SECA Tax

Under current law, S-corporation shareholders and limited partners are not subject to self-employment tax on pass-through income. However, the Green Book proposes changing that for high-income taxpayers with adjusted gross income of more than $400,000.

The proposal would ensure that all trade or business income of high-income taxpayers is subject to the 3.8 percent Medicare tax, either through the net investment income tax (NIIT) or the Self-Employment Contributions Act (SECA) tax.

- The NIIT base would be expanded to include income and gain from trades or businesses not otherwise subject to employment taxes, and the 3.8% NIIT tax would be redirected to the Hospital Insurance Trust Fund.

- The 3.8% SECA tax would apply to the ordinary business income of high-income nonpassive S corporation owners (those whose AGI is greater than $400,000).

- Limited partners and LLC members who provide services and materially participate in their partnerships and LLCs would be subject to SECA tax on their distributive shares of partnership or LLC income to the extent that this income exceeds certain threshold amounts. The exemptions from SECA tax provided under current law for certain types of S corporation income (e.g., rents, dividends and capital gains) would continue to apply to these types of income.

Material participation standards would apply to individuals who participate in a business in which they have a direct or indirect ownership interest. Taxpayers are usually considered to materially participate in a business if they are involved in it in a regular, continuous and substantial way. Often, this means they work for the business for at least 500 hours per year. The statutory exception to SECA tax for limited partners would not exempt a limited partner from SECA tax if the limited partner otherwise materially participated.

To determine the amount of partnership income and S corporation income that would be subject to SECA tax under the proposal, the taxpayer would sum:

(a) ordinary business income derived from S corporations for which the owner materially participates in the trade or business and

(b) ordinary business income derived from either limited partnership interests or interests in LLCs that are classified as partnerships to the extent a limited partner or LLC member materially participates in its partnership's or LLC's trade or business (this sum is referred to as "potential SECA income").

Beginning in 2022, the additional income that would be subject to SECA tax would be the lesser of:

(i) the potential SECA income or

(ii) the excess over $400,000 of the sum of the potential SECA income, wage income subject to FICA under current law, and 92.35 percent of self-employment income subject to SECA tax under current law.

The $400,000 threshold amount would not be indexed for inflation.

Limit Nonrecognition of Like-Kind Exchanges

The Tax Cuts and Jobs Act did away with all Sec 1031 "like-kind" exchanges (tax-deferred exchanges) except those related to real property. The Green Book proposes going a step further and would limit eligibility for Section 1031 exchanges by permitting each taxpayer to defer only up to $500,000 ($1 million for married taxpayers filing jointly) of real property gain each year. Any gain more than the $500,000 ($1 million) limit would be recognized as taxable income in the taxable year in which the taxpayer transfers the real property. These changes would require REITs to distribute gains on property sales that could otherwise be deferred under Section 1031. Caution: The proposal would apply these rules to exchanges "completed after taxable years beginning after December 31, 2021. However, deferred exchanges may be completed in 2022, but the property given up may have been transferred in 2021, and thus may be taxable in 2021.

Transfer of Appreciated Property by Gift or Death

The Green Book proposes changes to the rules for a gift donor or a deceased owner if an appreciated asset would realize a capital gain at the time of the transfer. The capital gain would be the excess of the asset's fair market value (FMV) on the date of a deceased owner's death (or the date the gift is given) over the decedent's or donor's basis in the property.

The resulting gain would be taxable income for the decedent on a Form 709 Federal Gift Tax Return, Form 706 Estate Tax Return or a separate capital gains return.

These changes would be effective for gains on property transferred by gift, property owned at death by decedents dying after December 31, 2021 and certain property owned by trusts, partnerships and other non-corporate entities on January 1, 2022.

Normal gift or estate tax methodologies will be used to determine an asset's FMV. However, for this tax on appreciated assets, the following would apply:

- Partial Interests - The FMV of a partial interest will be based upon a proportional share of the FMV of the entire property.
- Transfers - Transfers of property into and distributions in kind from a trust, partnership or other non-corporate entity (other than a grantor trust that is deemed to be wholly owned and revocable by the donor) would be recognition events.

The deemed owner of a revocable grantor trust would recognize gain on the unrealized appreciation of any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner, other than a distribution made in discharge of an obligation of the deemed owner. All the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time the trust becomes irrevocable.

90-year rule - Gain on unrealized appreciation would also be recognized by a trust, partnership or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. The testing period for this provision would begin on January 1, 1940. Thus, the first possible recognition event under this provision would be December 31, 2030.

Exclusions – Certain exclusions apply to the foregoing gain recognitions.

  - Transfers to a spouse or charity. Transfers by a decedent to a U.S. spouse or charity would have the following effects:
  - The basis of the decedent would carry over to the spouse or charity.
  - Capital gain would not be recognized until the surviving spouse disposes of the asset or dies.
  - Appreciated property transferred to charity would not generate a taxable capital gain.
  - Transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes.

- Tangible property and principal residence. The proposal would exclude from recognition any gain on tangible personal property, such as household furnishings and personal effects (excluding collectibles). The $250,000 per-person exclusion under current law for capital gain on the sale of a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple.
- Small business stock. The exclusion under current law for capital gain on certain small business stock under **Code Sec. 1202** would continue to apply.
- New $1 million exclusion. The Green Book proposal would also allow a $1 million per-person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death, and will be inflation-adjusted after 2022. Thus, for a married couple, the exclusion would be $2 million.
  - The recipient's basis in property received by reason of the decedent's death would be the property's FMV at the decedent's death.
  - In the case of a gift, the recipient's basis is the donor's basis less any amount excluded by the donor using the $1 million exclusion.
  - Also, in the case of a gift, the donor would be subject to tax on unrealized gain

less any amount excluded by the donor's $1 million exclusion.

Family-Owned and -Operated Businesses - Payment of tax on the appreciation of certain family-owned and -operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and -operated.

15-Year Fixed-Rate Payment Plan - Furthermore, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and businesses for which the deferral election is made. The IRS would be authorized to require security at any time there is a reasonable need for security to continue this deferral. That security may be provided from any person, and in any form, deemed acceptable by the IRS.

Excess Business Loss Limitation

Excess business loss is defined as the excess of losses from business activities over the sum of (a) gains from business activities and (b) a specified threshold amount. In 2021, these thresholds are $524,000 for married couples filing jointly and $262,000 for all other taxpayers; these amounts are indexed for inflation thereafter. The determination of excess business loss is made at the taxpayer level, aggregating across all business activities. However, gains or losses attributable to any trade or business of performing services as an employee are not considered. This provision is set to expire after 2026.

The Green Book proposal would make the excess business loss limitation permanent for non-corporate taxpayers.

Corporate Tax Rate

Before the Tax Cuts and Jobs Act of 2017 (the TCJA), the highest marginal tax rate that applied to corporations was 35%. The Green Book proposes raising the corporate tax rate from the current 21% to 28%. The proposal would be effective for tax years beginning after 2021. However, there has been some news that the Biden administration may be willing to compromise on this issue and leave the rate at the current 21%.

A 15% minimum tax on the book earnings of certain large corporations is also being proposed.

Carried Interest

The proposal would generally treat partnership income from carried interests as ordinary income subject to self-employment tax. Currently, this type of income is eligible for preferential long-term capital gains rates.

Enhanced Financial Account Reporting

The proposal includes a new comprehensive financial account information-reporting regime for banks and other financial institutions beginning in 2023. Financial institutions would be required to report gross inflow and outflow of accounts to the IRS annually, with a breakdown for physical cash, transactions with foreign accounts and transfers to and from another account with the same owner. Similar reporting requirements would apply to crypto asset exchanges and custodians. While the purpose of this provision, as explained in the Green Book, is to provide more data to the IRS so they will have better "visibility of gross receipts and deductible expenses" of businesses, this requirement would apply to all business and personal accounts from financial institutions, including bank, loan and investment accounts, except for accounts below a gross flow threshold or FMV of $600.

Many of the provisions included in this article are complicated, and not all the Green Book proposals have been covered. If you feel you need additional information, please give this office a call. Remember, these provisions are the Biden administration's wish list and may not be passed into law as outlined in the Green Book.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

Scott Jensen
Kramer & Jensen, LLC

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sjensen@kramerjensen.com

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