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Newsletter October 2021

October 2021 Due Dates

October 15 - Individuals

If you requested an automatic 6-month extension to file your income tax return for 2020, file Form 1040 and pay any tax, interest, and penalties due.

October 15 - Corporations

File a 2020 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic 6-month extension by April 15.

Higher Income Individuals Beware

The House Ways and Means Committee has released an extensive list of proposed tax changes that could impact individual, retirement, international and corporate tax law if they become law. We have been selective and have only included a portion of the proposed changes. A full list of proposed changes is available from the PDF file titled **Responsibility Funding Our Priorities**.

As you read through the article you will quickly become aware that the provisions are aimed at higher income taxpayers. The full list available from the link above includes numerous provisions not included in this article and are primarily related to corporate foreign transactions.

- **Increase in Corporate Tax Rate -** This provision would replace the flat corporate income tax with a graduated rate structure. The rate structure would provide for a rate of 18 percent on the first $400,000 of income; 21 percent on income up to $5 million, and a rate of 26.5% on income thereafter. The benefit of the graduated rate would phase out for corporations making more than $10,000,000. Personal services corporations would not be eligible for graduated rates. The domestic dividends received deduction would be adjusted to hold constant the tax on domestic corporate-to-corporate dividends.

- **Increase in Top Marginal Individual Income Tax Rate -** The provision would increase the top marginal individual income tax rate to 39.6%. This marginal rate would apply to married individuals filing jointly with taxable income over $450,000, to heads of households with taxable income over $425,000, to unmarried individuals with taxable income over $400,000, to married individuals filing separate returns with taxable income over $225,000, and to estates and trusts with taxable income over $12,500. The amendments made by this section would apply to taxable years beginning after December 31, 2021

- **Increase in Capital Gains Rate for Certain High-Income Individuals** - The provision would increase the capital gains rate to 25%. The amendment made by this section would apply to taxable years ending after the date of introduction of this Act. A transition rule would provide that the preexisting statutory rate of 20% continues to apply to gains and losses for the portion of the taxable year prior to the date of introduction. Gains recognized later in the same taxable year that arise from transactions entered into before the date of introduction pursuant to a written binding contract would be treated as occurring prior to the date of introduction.

- **Deduction for Certain Employee Trade or Business Expenses** - The provision would allow for up to $250 in dues to a labor organization be claimed as an above-the-line deduction. The provision would be effective for taxable years beginning after December 31, 2021.

- **Application of Net Investment Income Tax to Trade or Business Income** - This provision would expand the net investment income tax to cover net investment income derived in the ordinary course of a trade or business for taxpayers with greater than $400,000 in taxable income (single filer) or $500,000 (joint filer), as well as for trusts and estates. The provision would clarify that this tax is not assessed on wages on which FICA is already imposed. This would be effective for taxable years beginning after December 31, 2021.

- **Limitation Qualified Business Income Deduction** – The provision would amend IRC Sec 199A pass through deduction by setting the maximum allowable deduction at $500,000 in the case of a joint return, $400,000 for an individual return, $250,000 for a married individual filing a separate return, and $10,000 for a trust or estate. (It would become effective for taxable years beginning after December 31, 2021).

- **Limitations on Excess Business Losses of Noncorporate Taxpayers** - This provision would permanently disallow excess business losses (i.e., net business deductions more than business income) for non-corporate taxpayers. The provision would allow taxpayers whose losses are disallowed to carry those losses forward to the next succeeding taxable year. It would be effective for taxable years beginning after December 31, 2021.

- **Surcharge on High-Income Individuals, Trusts, and Estates** - This provision would impose a tax equal to 3% of a taxpayer's modified adjusted gross income more than $5,000,000 ($2,500,000 for married individuals filing separately). It would become effective for taxable years beginning after December 31, 2021.

- **Termination of Temporary Increase in Unified Credi**t - This provision would terminates the temporary increase in the unified credit against estate and gift taxes which for 2021 is $11,700,000, reverting the credit to its 2010 level of $5,000,000 per individual, indexed for inflation.

- **Estate Tax Valuation for Real Property Used in Farming** - This provision would increase the special valuation reduction available for qualified real property used in a family farm or family business. This reduction allows decedents who own real property used in a farm or business to value the property for estate tax purposes based on its actual use rather than fair market value. This provision would increases the allowable reduction from $750,000 to $11,700,000.

- **Certain Tax Rules Applicable to Grantor Trusts** - This provision would add IRC Sec 2901, which would pull grantor trusts into a decedent's taxable estate when the decedent is the deemed owner of the trusts. Prior to this provision, taxpayers are able to use grantor trusts to push assets out of their estate while controlling the trust closely. The provision would also add a new section 1062, which treats sales between grantor trusts and their deemed owner as equivalent to sales between the owner and a third party. The amendments made by this section would apply only to future trusts and future transfers.

- **Valuation Rules for Certain Transfers of Nonbusiness Assets** - This provision would clarify that when a taxpayer transfers nonbusiness assets, those assets should not be afforded a valuation discount for transfer tax purposes. Exceptions would be provided for assets used in hedging transactions or as working capital of a business. A look-through rule would provide that when a passive asset consists of a 10-percent interest in some other entity, the rule would be applied by treating the holder as holding its ratable share of the assets of that other entity directly. The amendments made by this section would apply to transfers after the date of the enactment of this Act.

- **Contribution Limits for Individual Retirement Plans -** Under current law, taxpayers may make contributions to IRAs irrespective of how much they already have saved in such accounts. To avoid subsidizing retirement savings once account balances reach very high levels, the legislation would create new rules for taxpayers with very large IRA and defined contribution retirement account balances. Specifically, the legislation would prohibit further contributions to a Roth or traditional IRA for a taxable year if the total value of an individual's IRA and defined contribution retirement accounts generally exceed $10 million as of the end of the prior taxable year. The limit on contributions would only apply to single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of households with taxable income over $425,000 (all indexed for inflation). The legislation would also add a new annual reporting requirement for employer defined contribution plans on aggregate account balances more than $2.5 million. The reporting would be to both the Internal Revenue Service and the plan participant whose balance is being reported. This would become effective for taxable years beginning after December 31, 2021.

- **Increase in Minimum Required Distributions -** If an individual's combined traditional IRA, Roth IRA and defined contribution retirement account balances generally exceed $10 million at the end of a taxable year, a minimum distribution would be required for the following year. This minimum distribution would only be required if the taxpayer's taxable income is above the thresholds described in the section above (e.g., $450,000 for a joint return). The minimum distribution generally would be 50 percent of the amount by which the individual's prior year aggregate traditional IRA, Roth IRA and defined contribution account balance exceeds the $10 million limit. In addition, to the extent that the combined balance amount in traditional IRAs, Roth IRAs and defined contribution plans exceeds $20 million, that excess would be required to be distributed from Roth IRAs and Roth designated accounts in defined contribution plans up to the lesser of (1) the amount needed to bring the total balance in all accounts down to $20 million or (2) the aggregate balance in the Roth IRAs and designated Roth accounts in defined contribution plans. Once the individual distributes the amount of any excess required under this 100 percent distribution rule, then the individual would be allowed to determine the accounts from which to distribute to satisfy the 50 percent distribution rule above. This would become effective for taxable years beginning after December 31, 2021.

- **Limiting Back Door IRA Conversion**s **-** Under current law, contributions to Roth IRAs have income limitations. For example, the income range for single taxpayers for making contributions to Roth IRAs for 2021 is $125,000 to $140,000. Those single taxpayers with income above $140,000 generally are not permitted to make Roth IRA contributions. In 2010, the similar income limitations for Roth IRA conversions were repealed, which allowed anyone to contribute to a Roth IRA through a conversion. irrespective of the still-in-force income limitations for Roth IRA contributions. As an example, if a person exceeds the income limitation for contributions to a Roth IRA, he or she can make a nondeductible contribution to a traditional IRA – and then shortly thereafter convert the nondeductible contribution from the traditional IRA to a Roth IRA. To close these so-called **"back-door"** Roth IRA strategies, the bill would eliminate Roth conversions for both IRAs and employer-sponsored plans for single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of households with taxable income over $425,000 (all indexed for inflation). This provision would apply to distributions, transfers, and contributions made in taxable years beginning after December 31, 2031. Furthermore, this section would prohibit all employee after-tax contributions in qualified plans and prohibit after-tax IRA contributions from being converted to Roth regardless of income level, effective for distributions, transfers, and contributions made after December 31, 2021.

- **Statute of Limitations with Respect to IRA Noncompliance -** The bill would expand the statute of limitations for IRA noncompliance related to valuation-related misreporting and prohibited transactions from 3 years to 6 years to help IRS pursue these violations that may have originated outside the current statute's 3-year window. This provision would apply to taxes to which the current 3-year period ends after December 31, 2021.

- **Investment of IRA Assets in Entities Where Owner Has a Substantial Interest** - To prevent self-dealing, under current law prohibited transaction rules, an IRA owner cannot invest his or her IRA assets in a corporation, partnership, trust, or estate in which he or she has a 50 percent or greater interest. However, an IRA owner can invest IRA assets in a business in which he or she owns, for example, one-third of the business while also acting as the CEO. The bill would adjust the 50 percent threshold to 10 percent for investments that are not tradable on an established securities market, regardless of whether the IRA owner has a direct or indirect interest. The bill would also prevent investing in an entity in which the IRA owner is an officer. Further, the bill would modify the rule to be an IRA requirement, rather than a prohibited transaction rule (i.e., to be an IRA, it must meet this requirement). This section generally would take effect for tax years beginning after December 31, 2021, but there would be a 2-year transition period for IRAs already holding these investments.

- **IRA Owners Treated as Disqualified Persons** - The bill would clarify that, for purposes of applying the prohibited transaction rules with respect to an IRA, the IRA owner (including an individual who inherits an IRA as beneficiary after the IRA owner's death) is always a disqualified person. This section would apply to transactions occurring after December 31, 2021.

- **Funding of the Internal Revenue Service** - This provision would appropriate $78,935,000,000 for necessary expenses for the IRS for strengthening tax enforcement activities and increasing voluntary compliance and modernizing information technology to effectively support enforcement activities. No use of these funds would be intended to increase taxes on any taxpayer with taxable income below $400,000. Further, $410,000,000 would be appropriated for necessary expenses for the Treasury Inspector General for Tax Administration to provide oversight of the IRS. Finally, $157,000,000 would be appropriated for the Tax Court for adjudicating tax disputes. These appropriated funds are would remain available until September 30, 2031.

- **Limiting Qualified Conservation Contribution Deductions** - To curb syndicated conservation easement tax shelters, this provision would deny charitable deduction for contributions of conservation easements by partnerships and other pass-through entities if the amount of the contribution (and therefore the deduction) exceeds 2.5 times the sum of each partner's adjusted basis in the partnership that relates to the donated property. This general disallowance rule would not apply to donations of property that meet the requirements of the 3-year holding period rule, and contributions by family partnerships. In addition, certain taxpayers whose deeds are found to have certain defects and are notified by the Commissioner could correct such defects within 90 days of the notice. This ability to cure would not apply in the case of reportable transactions and transactions for which deduction is disallowed under this section. Various accuracy-related penalties would apply, including gross valuation misstatement penalty, and adjustments would be made to the statute of limitations on assessment and collection by the IRS, in case of any disallowance of a deduction by reason of this provision. This section would apply to contributions made after December 23, 2016 (the date of the relevant IRS Notice). In the case of contributions of easements related to the preservation of certified historic structures, this section would apply to contributions made in taxable years beginning after December 31, 2018. The ability to cure defective deeds would be permitted for returns filed after the date of the enactment and for returns filed on or before such date if the section 6501 period has not expired as of such date.

- **Limitation on Deduction of Excessive Employee Remuneration** - This provision would move up the effective date of the amendment to section 162(m) in the American Rescue Plan Act of 2021 (ARPA) to tax years following December 31, 2021. The ARPA expanded the set of applicable employees under section 162(m) to include the eight most highly compensated officers other than the principal executive and principal financial officers for a taxable year, beginning in tax years after December 31, 2026. The additional five employees scoped in under the ARPA amendment would not considered permanent covered employees for the purposes of the section. The provision would also apply the section 414 aggregation rules for covered health insurance providers to the general rule under section 162(m), expands the IRS's regulatory authority under the general rule, and expands the definition of applicable employee renumeration.

- **Termination of Employer Credit for Paid Family Leave and Medical Leave** -This provision would accelerate termination of employer credit for wages paid to employees during family and medical leave to taxable years beginning after 2023. Currently, the credit will terminate for wages paid in taxable years beginning after 2025.

- **Temporary Rule to Allow Certain S Corporations to Reorganize as Partnerships Without Tax -** This provision would allow eligible S corporations to reorganize as partnerships without such reorganizations triggering tax. Eligible S corporation would mean any corporation that was an S corporation on May 13, 1996 (prior to the publication of current law "check the box" regulations with respect to entity classification). The eligible S corporation would be required to completely liquidate and transfer substantially all its assets and liabilities to a domestic partnership during the two-year period beginning on December 31, 2021.

- **Enhancement of Work Opportunity Credit During COVID-19 Recovery Period** - This provision would increases the Work Opportunity Tax Credit (WOTC) to 50% for the first $10,000 in wages, through December 31, 2023, for all WOTC targeted groups except for summer youth employees. The increase would also be available for qualified wages earned by a WOTC target group employee in his or her second year of employment (current law limits allows WOTC to be claimed only on first-year wages).

- **Research and Experimental Expenditures** - This provision would delay the effective date of section 13206 of Public Law 115-97. That section provides for amortization of the research and experimental expenditures starting taxable years beginning after December 31, 2021. Under this provision, the amortization of research and experimental expenditures would begin for amount paid or incurred in taxable years beginning after December 31, 2025.

Of course, these are all proposed changes that must pass Congress. But this article provides advance notice of these proposed changes and the opportunity to plan your tax strategies should they become law. Please give this office a call if we can be of assistance.

Complications to the IRA-to-Charity Distribution Provision

Individuals are required to begin taking distributions from their IRA when they reach a certain age. That age was 70½ until Congress passed the SECURE Act in late 2019 which made significant changes to the retirement plan provisions of the tax code, one of which was to up the age for beginning required minimum distributions (RMD) to age 72. That change was supposed to occur with 2020 distributions, but due to the Covid-19 pandemic, Congress waived RMDs for 2020. So, 2021 is actually the first year that the age 72 rule is effective.

Prior to the passage of the SECURE Act, the tax code also restricted contributions to IRAs by individuals once they reached age 70½, which coordinated with the prior requirement to begin RMDs. That restriction has been eliminated, and as of 2020, individuals may make IRA contributions at any age provided they have earned income.

The tax code also includes another provision that allows taxpayers to transfer up to $100,000 from their IRA to qualified charities. The tax provision is called a Qualified Charitable Distribution (QCD), and has been a popular way for retirees to make charitable contributions that can provide significant tax benefits. Here is how this provision, if utilized, plays out on a tax return:

1. The IRA distribution is excluded from income.

2. The distribution counts toward the taxpayer's RMD for the year; and
3. The distribution does NOT count as a charitable contribution deduction.

At first glance, this may not appear to provide a tax benefit. However, by excluding the distribution, a taxpayer lowers his or her adjusted gross income (AGI), which helps for other tax breaks (or punishments) that are pegged at AGI levels, such as medical expenses if itemizing deductions, passive losses, taxable Social Security income, and so on. In addition, non-itemizers essentially receive the benefit of a charitable contribution to offset the IRA distribution.

Whether intentional or an oversight by Congress, the SECURE Act did not change the age at which a taxpayer can begin making QCDs and left it at age 70½ – no longer in synchronization with the revised RMD age of 72.

Tax Trap – Unfortunately that has created a situation that can be detrimental for individuals who have earned income and wish to utilize the QCD provisions and also continue to contribute to an IRA after age 70½.

The problem being that a QCD must be reduced by the sum of IRA deductions made after age 70½ even if they are not in the same year, causing unexpected tax results for taxpayers that are not aware of this complication. This is best explained by a couple of examples.
Example #1 – Jack makes a deductible IRA contribution of $7,000 when he is age 71 and another $7,000 contribution at the age of 72. He claims an IRA deduction of $7,000 on his tax return for each year. Then later when he is 74, he makes a QCD in the amount $10,000 to his church's building fund. Since Jack had made the IRA contributions after age 70½, his QCD must be reduced by the post-70½ contributions that were deducted, and as a result, the $10,000 is a taxable IRA distribution ($10,000 – 14,000 = <$4,000>). However, he can claim $10,000 to the church building fund as a charitable contribution on Schedule A if he itemizes his deductions. In the next year, Jack makes a $5,000 QCD to the university where he got his degree. The excludable amount of the QCD is $1,000 ($5,000 - $4,000 = $1,000). The $4,000 is the amount that remained from post-age 70½ IRA contributions that didn't previously offset QCDs. Jack includes $4,000 as taxable IRA income and can deduct $4,000 as a charitable contribution if he itemizes. No amount of post-age 70½ IRA contributions remains to reduce the excludable amount of QCDs for subsequent taxable years.
Example #2 – Bob makes a traditional IRA contribution of $7,000 when he is age 71 and another $7,000 contribution at the age of 72 and deducts the IRA contributions on his returns. Then later when he is 74, he makes a QCD in the amount $20,000 to his church's building fund. Since Bob had made the deductible IRA contributions after age 70½, his QCD must be reduced by the $14,000. As a result, of the $20,000 QCD, $14,000 is a taxable distribution, $6,000 is nontaxable, and Bob can claim a $14,000 charitable contribution.

All this can become quite complicated. If you are considering making a QCD and made IRA contributions after age 70½ and don't understand the tax ramifications, you should consider consulting with this office before you make the distribution.

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.

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