Proposed Tax Law Changes:
What You Need to Know!

Individual Income Taxes

One of the key changes in this proposal is to increase the top rate tax rate back up to 39.6%, which was expected. However, one of the biggest changes as a part of this is the compression of the 35% tax bracket, meaning you will hit the top tax bracket much more quickly. For single filers, you will hit the top bracket at $401,000 of income vs $523,600 previously while joint filers will hit the top bracket at $450,000 of income vs $628,300.

In addition, the "marriage penalty" was brought back in a big way. The most recent tax changes set up the brackets so that as you moved up the brackets, married couples essentially got a doubling of the single income levels before they would pass to the next tax bracket. This proposal dramatically changes that at the 35% bracket by only having about $50,000 of income eligible in that bracket before you hit the top rate. While it is tough to make marriage decisions based on income taxes, it will force many, especially those who are not married yet, to at least have the conversation around whether it makes sense financially to tie the knot!

Long-Term Capital Gains Rate

While many feared that we would see the top rate for capital gains tax aligned with the top income tax rate, what we are seeing at this point is a much smaller increase – from 20% to 25% on Long Term Capital Gains. However, income when this higher rate kicks in is much lower, $400,000 for single and $450,000 for married filers whereas the previous guidance would be that the top capital gains rate would not kick in until $1,000,000 of income. In addition, this is the one change that will take effect immediately upon the release (if the bill is passed) so that any transactions that occur after September 13th would be subject to the higher rate. There are a few exclusions to this, primarily if you had a binding contract to sell your business in place prior to September 14th.

Goodbye to the Backdoor Roth IRA

Due to income limit rules, many middle to high income earners have not been eligible to contribute to a Roth IRA. However, there are rules in place that have allowed a "back door" into funding a Roth IRA through an After-Tax Traditional IRA contribution and then converting that to a Roth IRA with little or no tax consequences. In addition, some 401(k)s had a "mega back door" Roth strategy by allowing as much as $58,000 in after tax contributions that could be converted. These strategies are dead in the water under the new proposal as well as a phase out of the ability to do any Roth Conversions at all for higher income earners in 10 years.

Changes for Business Owners

There were 2 changes proposed that specifically impact business owners utilizing an S Corporation designation. Currently, profits of S corporations are NOT subject to employment tax or Net Investment Income Tax (NIIT), a 3.8% surtax that was implemented on investment income above $200,000 per year back in 2013. This bill would now subject S Corporation earnings to this tax, with some phase-ins at $400,000 of Modified Adjusted Gross Income (MAGI) for single filers and $500,000 for joint filers.

In addition, for very high-income S Corporation owners, there will be an additional 3% surtax for incomes above $5 million. For those business owners, this potentially makes their effective highest tax rate 46.4%.

Corporations were not spared either, replacing the current 21% flat rate, the proposed graduated rate starts at 18% on the first $400,000, 21% on income up to $5 million, 26.5% on income above $5 million. This graduated rate would phase out for corporations that make more than $10 million.

Estate Tax Changes

The Proposal would revert the unified credit against estate and gift taxes to $5 million per taxpayer for 2022 and in the future, adjusted for inflation, which works out to an estimated $5.8 million, or about half of what the current exemption is. This was highly expected to be a part of the proposal as it really is just pushing forward the changes that were set to happen in 2026 with the sunsetting of the previous tax law changes.

What makes this change a bit more challenging is that it also eliminates many of the planning strategies that were used to move assets out of an estate so that estate taxes could be mitigated, primarily through Grantor Trusts. The specific details of these changes are pretty technical but suffice it to say that many of the acronyms like GRAT, SLAT, IDGT and ILIT will no longer be valid strategies.

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