Will Tax Law Changes Increase Your Taxes?

Will you be paying more in taxes next year? Let's ask the question in another way. Since politicians have taken aim at high earners: Are taxes going to rise for the wealthiest taxpayers?

Clients usually ask, "How will this affect me?" or "Will I be ensnared by Congress' definition of wealthy?"

If proposed changes in the tax code that passed a House committee are enacted into law, those that are wealthy, as defined by lawmakers, will likely see their taxes rise.

The major provisions include:

- Raising the top federal tax rate from 37% to 39.6%,
- Levying a 3% surtax on income higher than $5 million for single and joint filers,
- Raising the tax on dividends and the long-term capital gains tax rate for assets held over one year to 25% (up from 20%) for individuals earning more than $400,000 and for couples that earn over $450,000,
- Placing new limits on those who have large retirement account balances, and
- Putting new limits on QBI deduction for pass-through firms.

These proposals are a long way from becoming law but are winding their way through Congress. The Senate may have its own set of proposals, which would require both legislative bodies to forge a compromise before a tax bill lands on the President's desk.

Moreover, a sharply divided Senate seems likely to pare $3.5 trillion in proposed spending, assuming legislators in the House compromise on new outlays. If new spending is reduced, smaller tax hikes could follow.

While a wait-and-see approach may serve some folks well, we understand that planning for any changes reduces the odds of an unwanted surprise.

We are providing general guidelines. We understand that your situation is unique, and we would be happy to entertain any questions and tailor our recommendations to your needs. As always, feel free to consult with your tax advisor regarding any tax-related questions.

The proposed increase in the top tax rate and the surcharge on income over $5 million. A couple filing jointly that has $600,000 of taxable will see their top rate rise from 35% to 39.6% next year, if proposed changes are enacted (4.6 percentage points, or a $6,900 increase in taxes on $150,000 of income).

However, there are ways to minimize the tax sting next year.

Consider shifting 2022 income into tax year 2021, which would be subject to today's lower rate. And look for ways to defer expenses and deductions that you might normally incur in 2021 and push them into 2022.

Maximize contributions to tax-deferred savings and retirement accounts. If you itemize deductions, charitable contributions will reduce your taxable income.

In addition, municipal bonds, which are exempt from federal income tax, will become more attractive if a higher marginal tax rate is enacted.

The proposed 3% surtax on individuals earning over $5 million would effectively raise the top tax rate to 42.6%. This would hit very few taxpayers—but be aware that the sale of a business or large asset could push you above the threshold.

Please note that the surcharge is separate from today's 3.8% tax on net investment income.

A higher rate on dividends and long-term capital gains tax rate is being considered. As proposed, if a capital gain is realized on or after September 14, 2021, individuals earning more than $400,000 and couples earning over $450,000 will pay a top rate of 25%. The same would hold true with dividends.

As drafted, it would be too late to incur a long-term capital gain at 2021's lower rate.

You may consider deferring gains, as an unrealized capital gain would not be subject to taxes. Or rates may decline again in the future. As we commented up top, much depends on your individual circumstances.

There will be new RMD requirements for individuals who have high income and large retirement accounts, regardless of age. If you exceed $400,000 and $450,000 in income for single and joint filers, respectively, AND retirement accounts total over $10 million, you will be subject to RMDs beginning in 2022. You will also be prohibited from making IRA contributions.

However, the restriction on contributions does not apply to employer-sponsored plans such as 401ks, SEP IRAs, or SIMPLE IRAs.

If your income is above the $400,000 and $450,000 limits *and* retirement accounts exceed $20 million (including a Roth IRA), you would be required to distribute funds from your Roth IRA.

New limits on QBI deduction. If you are self-employed, the House proposal limits the deduction to $500,000 for joint returns and $400,000 for individual returns. Once you have exceeded the cap, additional amounts will be disregarded.

Left on the cutting room floor

Lawmakers in the House have not proposed taxing unrealized capital gains at death, as had initially been proposed by the President. Also, the step-up in basis for inherited assets is NOT in the current House proposal.

But one proposal being floated is to reduce the estate and gift tax exemption to $5 million. Tax reform in 2017 raised the limit to $11.7 million of individuals and $23.4 million for couples.

Bottom line

These are some of the major provisions. They may or may not be enacted into law.

We understand that taxes play a role in overall returns, but so do many variables. Your financial plan should ultimately drive investment decisions, not tax laws. Don't let the tail wag the dog. In other words, be careful not to let taxes solely dictate your investment decisions.

Sources and further reading

[[https://www.wsj.com/articles/capital-gains-and-capital-pains-in-the-house-tax-proposal-11633080602 Capital Gains and Capital Pains in the House Tax Proposal]]

[[https://www.schwab.com/resource-center/insights/content/will-taxes-rise-wealthy-what-you-should-know Will Taxes Rise for the Wealthy?]]

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[[https://www.cnbc.com/2021/09/13/house-democrats-plan-drops-repeal-of-a-tax-provision-for-inheritances.html House Democrats' Plan Drops Repeal of a Tax Provision for Inheritances]]

What is it about September?

September has historically been the worst month for stocks, according to St. Louis Federal Reserve data measuring monthly S&P 500 performance over the last 50 years. If you are wondering whether the trend has abated in recent years, the answer is no, it hasn't. Over the last 10 years, September performance has been substandard.

While analysts have offered various explanations, no one has pinpointed the reason we sometimes see seasonal weakness as summer concludes.

Look no further than the table of Key Index Returns. The S&P 500 Index fell 4.8% in September. It was the first monthly decline since January and the worst decline since March 2020 when the lockdowns began.

Key Index Returns

	MTD %	YTD%
Dow Jones Industrial Average	-4.3	10.6
NASDAQ Composite	-5.3	12.1
S&P 500 Index	-4.8	14.7
Russell 2000 Index	-3.1	11.6
MSCI World ex-USA*	-3.2	7.1
MSCI Emerging Markets*	-4.3	-3.0
Bloomberg Barclays US Aggregate Bond Total Return	-0.9	-1.6

Source: MSCI.com, Bloomberg, MarketWatch
MTD: returns: August 31, 2021—September 30, 2021
YTD returns: December 31, 2020—September 30, 2021
*in US dollars

Peaking at a new record on September 2, the broad-based S&P 500 Index began a pullback that can be tied to a number of factors.

Before we continue, a 4.8% drop is modest by market standards. In fact, we've yet to shed 10% since the bull market began in late March 2020, which would be considered a "correction" by analysts.

So, what's behind the sell-off last month?

The economy is not contracting, and a moderation was expected after Q2's 6.7% annualized growth rate (U.S. BEA), but the slowdown has been more pronounced than expected.

The Atlanta Fed's GDPNow model, which incorporates economic data that impacts GDP, suggests that Q3 growth is tracking at just 2.3%. This would include Q3 data released through October 1. That means all of July, most of August and none of October's data have been inputted into the model.

While profit growth has soared coming out of the lockdowns, per Refinitiv, a more pronounced moderation in profit growth may be on tap.

Next question, why is Q3 disappointing on the economic front? Well, the spike in Covid cases is causing some hesitation in industries that are dependent on face-to-face transactions. But there is good news on this front. The CDC says cases have slowed recently. We'll see how this continues to play out later in the fall. While bank deposit data from the St. Louis Federal Reserve suggest consumers have plenty of spendable cash in reserve, the influx of new stimulus money has dwindled, and spending has slowed. We're also seeing stubbornly high inflation in some industries, as supply chain bottlenecks aren't fixing themselves.

Consider the title of this [[https://www.wsj.com/articles/why-is-the-supply-chain-still-so-snarled-we-explain-with-a-hot-tub-11629987531 *Wall Street Journal* story]] from late August:

Why Is the Supply Chain Still So Snarled?
We Explain, With a Hot Tub.
Utah manufacturer Bullfrog Spas depends on a complicated network to bring materials from across continents and oceans. The pandemic put it out of whack.

That sums up the problem for many manufacturers.

As Fed Chief Jerome Powell noted at the end of September, bottlenecks and shortages of key raw materials are "not getting better—in fact at the margins (they are) apparently getting a little bit worse."

Like severe labor shortages, supply chain problems are crimping profitability, limiting sales, raising prices, and hampering economic growth. Investors are taking note.

An uptick in bond yields near the end of the month also dampened sentiment. While yields remain quite low, they ticked higher after the Federal Reserve took on a slightly more hawkish tone at the September 22 meeting.

These are probably the biggest reasons for the pullback last month.

Not to be Debbie Downer, but let's look at a few more.

The debate over the debt ceiling is taking shape. The U.S. Treasury has said it will run up against the current debt ceiling on October 18. That means it can no longer borrow to fund operations, and the U.S. would default on its debt unless Congress extends the ceiling.

As Moody's Analytics recently noted, "The debt ceiling will be raised. Not doing so would be catastrophic for the economy, so this is an extremely low probability event."

We've seen this drama play out before, and lawmakers avoided sailing into uncharted waters. Still, it's causing some headline anxiety. As of early October, it looks like Congress will kick the can to December, which may lead to additional angst.

China's largest and most indebted property developer is on the brink of bankruptcy. While Western financial exposure is likely limited, a disorderly default could create big problems for the world's second-largest economy.

Finally, an energy crisis is brewing in Europe, while natural gas prices hit new highs in Asia. They are running about six times what we see at home (Reuters).

The U.S. isn't directly affected, but these are costs that may get added to manufactured goods or could restrict output, adding to supply chain woes.

Final thoughts

We're overdue for at least a 10% correction. We know they tend to be unpleasant, but they are part of the investment landscape.

With all but the most aggressive and risk tolerant investors, we recommend a healthy portion of fixed income investments. Adding a mix of bonds into the portfolio smooths out returns. We don't see the extreme highs when stocks are rising but mixing in fixed income reduces your risk on the downside when equities turn lower.

As we've noted in the past, stocks tend to take the stairs up and the elevator down. If we are headed toward an overdue correction, pullbacks tend to be short lived.

If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

Tim, Joe, Steve and Ryan