OFFSETTING THE UNKNOWN: HOW TO PLAN PROACTIVELY IF NEW TAX INITIATIVES ARE ENACTED BY BIDEN ADMINISTRATION

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Prior to the recent presidential election, Director of Commerce Family Office John Welsh, J.D., presented potential policy objectives from the campaign platforms of both candidates. Now that the Democrats have gained control of the White House and Congress, John gives his current perspective on those proposals as the new administration moves forward. He offers some insights to help counsel individuals and families on the development and implementation of estate, wealth transfer, philanthropic, and a variety of other related wealth planning matters. While the details of any possible legislative tax changes are subject to many political influences yet to be determined, we did want to make you aware of some of the potential planning opportunities that could become important in the coming months under the new administration. It is never too early to thoughtfully plan for potential outcomes.

We are currently in a tax environment like no other. It appears that permanency is gone, and uncertainty is here to stay. Because of this, taxpayers need to be flexible and ready for change to happen at any time, while also being aware that even if tax changes occur this year, election results in 2022 and 2024 could result in the tax pendulum being swung back the other way yet again. Flexibility is key.

The American Taxpayer Relief Act of 2012, better known as "ATRA", was supposed to have brought stability to tax planning. It averted a federal government fiscal cliff and made permanent many of the tax cuts that were part of the Bush tax cuts of 2001 and 2003. ATRA passed the Senate with a vote of 89-8. Many tax advisors believed that ATRA was finally going to be a period of tax stability, where you could advise taxpayers for the long-term without fear of sudden or temporary changes. That lasted only five years. The Tax Cuts and Jobs Act of 2017 ("TCJA") cut many taxes and brought many significant changes to the tax code, but similar to the Bush tax cuts, most are temporary and are designed to phase out over a ten-year period ending in 2026. Now, less than five years since TCJA passed we are facing the possibility of many of those changes being reversed early or completely modified.

Many commentators believed that if Democrats gained control of Congress and the White House in the 2020 elections, they would most likely pass sweeping tax changes. But with Democrats only controlling the Senate through a tie breaking vote of Vice President Harris and some Democratic Senators already voicing their unease with sweeping reforms, it is impossible to know whether they will be able to address tax legislation at all, whether it will occur in 2021 or 2022, whether it would apply retroactively or prospectively, and more importantly, what any tax legislation would actually look like. Additionally, one must remember that even if they do nothing, most of the TCJA tax cuts are temporary and are scheduled to revert to prior law in 2026. So, change is most likely coming one way or another.

That being said, what are some changes we might see enacted in 2021 and/or 2022? The following is a list of the most likely changes that Democrats may focus on between now and the 2022 elections.

- Individual Income Taxes. Currently, the top rate is 37% for income over $532,600 for single taxpayers and $628,300 for married couples filing jointly. The plan released by President Biden during the 2020 campaign increased the top bracket to 39.6% on income above $400,000 while keeping the rest of the brackets the same. The plan also increased the amount of income subject to social security taxes by applying the 12.4% rate to all income above $400,000 in addition to the income up to $142,800 that is currently subject to social security taxes, leaving income between the $142,800 and $400,000 not subject to the tax.
- Individual Capital Gain Taxes. Another part of President Biden's campaign plan was to increase the top long-term capital gains rate from 20% to the top rate of 39.6% for taxpayers with income above $1 million (these capital gains would also most likely be subject to the additional 3.8% Net Investment Income Tax, bringing the top rate to 43.4%).
- Estate Taxes. Another area of discussion has been to broaden the impact of the estate tax through some combination of lowering the estate tax exemption amount from $11,700,000 to $5,000,000 or $3,500,000, eliminating the ability of heirs to avoid capital gains tax on assets received through a process known as a step-up in basis, increasing the estate tax rate from 40% to 45%, and/or by requiring some sort of gain recognition on the appreciation of assets at one's death. These have been the most common changes discussed, but no matter which ones would be implemented, the most likely result could be to increase the number of individuals subject to an estate tax as well as the amount of tax imposed on estates.
- Corporate Taxes. The TCJA reduced the corporate tax rate from 35% to 21% and it was one of the permanent changes of the TCJA. One of the top priorities of the Biden administration may be to raise the corporate income tax rate from 21% to 28% with the potential to establish a new minimum tax for large corporations based on book income and not taxable income.

With all of this uncertainty, how does one plan for the potential changes listed above? With flexibility in mind. The following are some planning tools that taxpayers may find helpful to be flexibly proactive.

LET'S START WITH INDIVIDUAL TAXES. One of the main proposals of the Biden campaign was to reverse some of the individual tax cuts of the TCJA, specifically by raising taxes on individuals above a certain income threshold. If the changes discussed above do occur in 2021, the main question becomes whether the changes would be applied retroactively, as of the date of the legislation, or delayed until 2022. If the changes were applied retroactively to all income in 2021, taxpayers could not offset the increase in rates by adjusting the timing of income and deductions, but on the other hand, if the increase in rates is not retroactively applied, high-income taxpayers could accelerate income into 2021 and delay deductions into 2022 to offset the changes.

Since we don't know whether any changes could be retroactive or not, taxpayers could do what they do in their investment account, hedge and diversify. This means that taxpayers could look at income that would most likely be recognized in 2021 or 2022, including stocks with significant appreciation, and decide to recognize some of that income in 2021, while making sure not to accelerate too much income such that you would fall too far below the income limitations discussed above in future years. One may decide to look at their retirement accounts and decide to convert some of the accounts to Roth accounts, but not all as a way of hedging their income tax exposure. Another strategy may be to not time all your deductions to either now or December 31st, but to delay the major deductions, such as charitable gifts, until later in the year when we hopefully have more information so that you can decide whether they should be further delayed until 2022 or completed in 2021 depending on the legislative process.

While tax reform was a major component of the Biden campaign and it is still a possibility, one of the biggest unknowns is that even if legislation is passed in 2021, we don't know if it will be implemented retroactively, as of the date of the legislation, or start in 2022. Taxpayers need to be flexible with their planning to offset these unknowns. To do this, they should be looking ahead and determining how the different timing of legislation implementation will impact them and how they can plan to offset these changes. Only through planning and being flexible will taxpayers be able to adequately plan for the unknown.

NOW, LET'S LOOK AT ESTATE TAXES. Many commentators believe estate taxes are a high priority of change for the Biden administration because it impacts such a small percentage of taxpayers. Predictions on potential changes do vary widely though. Despite the unknowns, if one has remaining exemption, it might make sense to use that amount so as not to lose it should the exemption amount be decreased this year or next. Remember that even if nothing is done, exemption amounts are scheduled to go down in 2026. So, what are some ways to plan around these unknowns and be flexible with your planning?

One popular planning idea that provides flexibility is to create what is known as a Spousal Lifetime Access Trust (or Spousal Limited Access Trust), sometimes referred to as a SLAT. This trust allows one spouse to use his/her exemption amount, remove those assets from his/her estate, but also allows him/her to name his/her spouse as a beneficiary of the trust, thus giving the couple maximum flexibility. Note that both spouses can use their exemption and create trusts that name his/her spouse as a beneficiary, but it might be appropriate for only one of the spouses to make a gift using his or her exemption amount. The reason is that if both spouses were to make a $5.5 million gift, using that amount of exemption each and the exemption amount later decreases to $5.5 million or less per individual, the couple now has no exemption left between them. If they utilize the strategy of one spouse using his or her entire $11.58 million exemption amount now and the exemption amount decreases to $5.5 million or less, they will still have the other spouse's entire exemption amount remaining.

Other ways to provide flexibility to taxpayers who wish to plan now but are worried about having buyer's remorse based on the actions or inactions in Washington are to include disclaimer or contingent marital trust provisions in any trusts they create now before any legislation is passed. These provisions allow for a taxpayer to make a gift to a trust, use his/her exemption amount, and then wait a period of time for either the trustee of the trust or the beneficiaries to decide if it makes sense from an estate tax perspective to change the nature of the gift. Under a disclaimer, the beneficiaries of the trust would disclaim their interest in the gift within 9 months of the initial gift and the gifted assets could revert back to the donor, thus nullifying the gift and saving the exemption amount. Under a contingent marital trust or QTIP trust, the trustee of the trust has until the date a gift tax return is due for the donor to decide if the trust should be considered a marital, or QTIP, trust, and thus decide then whether to use exemption or not.

While these strategies do provide maximum flexibility, the descriptions above are overly simplified and are not to be implemented without careful thought and expert drafting by a qualified attorney. There are many pitfalls that could undo the intent of the plan or produce unwanted results.

FINALLY, LET'S ADDRESS CORPORATE AND BUSINESS TAXES. On the campaign trail, President Biden stated that he would raise the corporate tax rate to 28% and would enact a minimum tax on large companies, such that all large companies pay a minimum tax according to their book income, not just taxable income. While the impact these changes would have on the economy and markets is unknown, many corporations will be deciding whether it will be beneficial to accelerate income into 2021 and defer deductions or expenses later to offset the potentially higher tax rate.

Additionally, for years it was typically more beneficial from an overall tax perspective to be a pass-through entity compared to a corporation because earnings accrued inside a corporation and then distributed out to its owners are essentially taxed twice. This differential between pass-through entities and corporations was narrowed for many taxpayers as a result of TCJA. If there are changes to the corporate tax rate, individual tax rates and pass-through taxing structure like we saw in 2017, this analysis may again be altered, for better or for worse, and would require companies and taxpayers to again analyze its choice of entity. As such, companies and businesses need to be analyzing these changes and be ready for changes that could be beneficial to certain types of entities and harmful for certain industries that may be a target of future tax legislation.

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